Taxation and the B.C. Farmer

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TAXATION

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THE B.C. FARMER

SIXTH EDITION

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A study prepared for the B.C. Ministry of Agriculture and Fisheries, Farm Management Extension Branch.

Editor of the Sixth Edition - Derek J. Fryer, Chartered Accountant, partner in the firm of McKnight Johnson which has offices in Chilliwack, Abbotsford and Mission, B.C.

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Preface

As a farm manager concerned with developing and maintaining a profitable business, you are faced with making many different kinds of decisions. In addition to operating decisions concerning production systems, marketing and credit, decisions with longer term implications must be made. These will relate to acquisition, organization and use of farming assets and the eventual transfer of the business through sale or otherwise to someone else.

The purpose of this publication is to assist farmers with tax planning strategies for the farm business. The material presented here should not be considered a complete interpretation or a replacement for the legislation as the tax laws are continually changing. If you have any specific problems not answered by this or other publications, you should contact your tax consultant or farm business advisor for further information, guidance and assistance.

Each farm business is unique in terms of physical characteristics, structure, income level and the size, ages and aspirations of the farm family. Consequently your tax planning and estate planning should be documented and analyzed on its own merits in light of current legislation and may differ substantially from those of your neighbours.

Other Ministry publications which may assist you in the tax planning area include "Farm Business Corporations in British Columbia", "Farm Business Partnerships in British Columbia", "Estate Planning and the B.C. Farmer" and frequent tax related topics discussed in the "Farm Business Management Factsheet" series available through the Farm Management Extension Branch.

This publication was originally prepared by William A. Barclay, C.A., on a contract under the British Columbia Ministry of Agriculture "Demonstration of Agriculture Technology and Economics" Program (DATE). The fourth edition involved a major update in 1981 by Don Piche, C.A. This latest edition was prepared by Derek J. Fryer, C.A. and reflects not only the income tax law as it stood on January 1, 1987 but also the government's proposed changes as announced in the 1986 federal budget.

Although intended for use by farm managers in planning their business organization and tax management strategies, this publication is not meant to replace the "The Farmer's Income Tax Guide" published annually by Revenue Canada to assist with the filling out of income tax forms.

Terry Peterson, Supervisor
Farm Business Management
Farm Management Extension Branch
Vernon, B.C.
V1T 4K7

January 1987

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INTRODUCTION

This book was not written to help farmers prepare their income tax forms, although it may assist in doing that. Revenue Canada's "Farmer's Income Tax Guide" is published annually to assist farmers answer basic questions which arise at income tax time. This publication was written for two other very important reasons:

a) To stress the need for planning a person's tax affairs to accomplish his personal and financial goals within the boundaries of the law.

b) To help fill the need to communicate information about our tax laws to British Columbia farmers and those advising farmers in a professional capacity.

The first reason - planning - automatically gives rise to the second reason - knowledge of the tax laws. The problem is that the information that farmers require to plan their tax affairs is contained in several complex legal statutes and their regulations and in a mass of bulletins, circulars, jurisprudence and administrative practices. Few people have sufficient knowledge and experience in all these matters to advise a farmer on how to organize and conduct his affairs to minimize his tax burden. British Columbia farmers need a source of information dealing specifically with the tax problems that face farmers operating in this province.

The farmer should be aware of the importance of planning and how his tax burden will be affected by the business decisions which he makes. This layman's guide has been kept as brief and non-technical as possible. Hopefully, the average person can read this guide without becoming confused by a lot of tax jargon and lengthy illustrative examples.

Since the first edition of this booklet was released some very significant changes in the taxation field have occurred; the most recent one being the introduction of the lifetime capital gains deduction. In many respects the tax planning opportunities for farmers have increased due to changes in the federal income tax rules.

Tax law is not as constant, as it is ever-changing. Today's tax-planning strategies can become obsolete tomorrow because of changes in legislation. As most people are aware, hundreds of changes have occurred since Canada's major income tax reform was unveiled in 1971. More changes can be expected in the months ahead, particularly now that the government seems to be committed to a major overhaul of the present system.

It is hoped that the format established for this publication will enable further revisions to be made easily as the need arises. Up-to-date information on tax changes, in the hands of the people affected by them, is our major objective.

The response to this information has been most encouraging and indicates that there is a need for this type of information in the hands of people engaged in farming in this province.

The sixth edition incorporates changes made to the law up to January 1, 1987 and reflects the 1986 federal budget proposals which were passed into law in December, 1986.

Derek J. Fryer
Chartered Accountant
January, 1987

Chapter 1

FARMING -- AS THE TAX MAN SEES IT

When is a farm a farm? As foolish as that question may seem it is a matter that has to be decided before a person knows where he stands under our various federal and provincial tax laws. This question assumes considerable importance, for example, when the owner of a farming business dies or transfers farm property to his child by way of gift. At that time, persons who have been in the business of farming may be entitled to receive preferential treatment at the hands of the income tax collector. It could mean the difference between paying no income tax at all or being taxed very heavily.

For purposes of real property taxation, classification of a particular parcel of land as farm land may have a considerable number of implications - not the least of which is a lower tax burden.

Like most provinces in Canada (the exception being Quebec) British Columbia no longer levies an inheritance tax or a gift tax. These pieces of legislation were repealed in British Columbia effective January 24, 1977. While the British Columbia Succession Duty Act and the British Columbia Gift Tax Act were in force, however, they contained special definitions of a family farm and farming operation. These definitions were substantially different from the meaning of "farming" for the purposes of the federal Income Tax Act.

The Social Services Tax Act which authorizes the sales tax in British Columbia also has a definition of a bona-fide farmer.

So, before proceeding with our study on tax laws relating to farmers, let's determine, if we can, exactly what farming means under the Canadian Income Tax Act. We will also review the requirements for classification of a parcel of real estate as farm land for real property taxation and discuss the meaning of a bona-fide farmer for the sales tax exemption.

The Canadian Income Tax Act

The Income Tax Act includes the following activities under the definition of farming:

a) tillage of the soil
b) livestock raising or exhibiting
c) maintaining of horses for racing
d) raising of poultry
e) fur farming
f) dairy farming
g) fruit growing
h) the keeping of bees

In addition to these activities which are specifically mentioned in the law, the following operations normally qualify:

i) the growing of Christmas trees and certain reforestation projects
j) nurseries and greenhouses
k) operating a wild game reserve
l) trading in race horses
m) certain feed lot operations
n) operation of a chick hatchery
o) certain market gardening operations.

An activity such as trout farming or other form of aqua-culture would usually qualify as farming. There may be other farming activities which would qualify. Farming does not include trapping, however, or employment under another person engaged in the business of farming.

As you can see, the income tax definition is very wide. It sweeps in just about every kind of activity to which an average person would apply the word farming. To be in the business of farming the person involved must be carrying on a particular farming operation with a reasonable expectation that he will earn a profit from it. This question becomes very important in determining whether or not a person is a bona fide farmer, a hobby farmer (See Chapter 12) or just a person farming for his personal use and consumption. Hobby farmers are in the business for a profit while people involved in agricultural activities only for their own needs are not.

Real Property Taxes

The words farm land and farm are defined under the Assessment Act, the legislation governing the levy of real property taxes in British Columbia, as "an area of land classified as such by the assessor". That appears to give a rather free hand to the assessment people, but some specific policy guidelines have been adopted by the government on this matter. A Farm Business Management factsheet available from the Ministry of Agriculture and Fisheries describes the specific standards that must be met if a parcel of land is to be classified as a farm for property tax purposes.

British Columbia Sales Tax

Whether or not a person is a bona-fide farmer will determine the application of British Columbia sales tax to certain farm implements and machinery. A bona fide farmer, for purposes of the exemption from sales tax, is tied to the status of the farm operation for purposes of real property taxation. The regulations to the Social Services Tax Act which authorizes the sales tax say that

> "a 'bona fide farmer' means a person holding a farmland classification under the provisions of the 'Assessment Act'".

It is worth noting that the foregoing rules will be more restrictive than the definition of farming for income tax purposes. Also, only certain farm supplies and machinery are specifically listed as being exempt from the tax (a comlete listing is available from any Social Service Tax Office).

That is a short summary of some of the definitions of farming contained in the various federal and provincial taxing statutes. The fact that the definitions vary from one set of laws to another means that a farmer has to keep in mind which Act he is dealing with.

Chapter 2

ORGANIZATION OF THE FAMILY FARM

One of the most important questions to be answered in connection with the taxation of a farming business is the form of organization which should be used. Two farming operations may be identical in size, in value and in the amount of income they produce, yet they may be taxed very differently. The difference results from having different types of organizations under the law. In this chapter we will list the types of organizations which are commonly encountered and itemize some of their respective advantages and disadvantages. We will present a series of questions which should be answered by a farmer to arrive at a wise decision as to the most advantageous type of organization for his particular farm. There are no easy answers to this problem. It is essential that all factors be taken into consideration in deciding which form of business organization is most appropriate to a particular farmer's circumstances.

First let's look at the types of organizations which are most commonly encountered. These are:

a) Sole proprietorships
b) Partnerships
c) Corporations
d) Trusts and estates.

SOLE PROPRIETORSHIPS

This is undoubtedly the most common type of business form in the farming community. The farm assets are owned by the farmer as an individual (or perhaps jointly with his wife) and all the income produced by the business is reported by the farmer in his personal income tax return. The farmer is in the same position under the law as any other individual who carries on a business for himself.

The advantages of a sole proprietorship

i) Simplicity

It's simple! There is a lot to be said for simplicity when it comes to tax planning.

ii) Choice of fiscal year-end

A farmer can select any date as the fiscal year-end for his farming business and is not required to report his income on a calendar year basis. For example, he might decide that January 31 is the natural end of his business cycle. In that case, for the calendar year 1986 he would report his farming income for the fiscal period ended on January 31, 1986. If he commenced business on, say, June 1 of 1985, he would have eight months' income to report for 1986. For 1987, he would report his 12 months' income for the fiscal year

ended January 31, 1987. Once a fiscal year-end is chosen it must be adhered to unless permission is given by the income tax authorities to change it.

iii) Income-averaging methods can be utilized

As discussed in Chapter 5, an individual farmer is able to use income-averaging techniques to reduce his income tax burden. The two most important of these techniques are the five-year block averaging and forward averaging.

iv) Tax deferral on transfers of farm property

A tax-free rollover can be obtained on farm property (land, certain depreciable assets and eligible capital property (such as quota)) transferred to descendants either during the farmer's lifetime or at the time of his death.

v) Life-time capital gains deduction on certain property

The farmer will be exempt from tax on up to $500,000 of capital gains arising from the disposition after 1984 of capital property (land, buildings, equipment) used in his farming business (see Chapter 13). This exemption applies whether the disposition occurs during the farmer's lifetime or at the time of his death.

vi) Income splitting between husband and wife

A deduction may be claimed for wages paid to his wife for employment services rendered to his business.

vii) Principal residence

The farmer can retain the principal residence status of his home. This is discussed in Chapter 10.

viii) Unlimited drawings

There are no income tax limitations on the amount of cash which the proprietor withdraws from his business. There will be limitations if the farm is incorporated.

The disadvantages of a sole proprietorship

i) Progressive rates of individual tax

Since the farmer will be reporting all the income from his farm on his personal tax return he will be subject to tax at rates which, for 1987 in British Columbia, range from approximately 9% on the first dollar of taxable income to a high of approximately 53% on income in excess of $63,500. As mentioned above, income-averaging can be utilized to take some of the sting out of the tax cost but,

nevertheless, for farmers in high income brackets the tax can be substantial.

ii) No limitation of legal liability

Persons who are unincorporated do not have a shield from legal action which, to a degree, is provided by a limited company. In a practical, day-to-day sense such protection may not make a great deal of difference to the majority of farmers.

However, if an incorporated farm encounters financial difficulties, the assets held outside the corporation could be protected from the claims of creditors except to the extent that the farmer has given his personal guarantee. If the farm is unincorporated no such protection is available, unless the farmer has purchased liability insurance.

iii) Transferability of ownership is more difficult

Where a business is owned by a sole proprietor, ownership of the assets such as real property, vehicles, equipment, registered livestock, etc., is recorded in the name of the sole proprietor. Transferring the ownership of such a business is more cumbersome than it is if all the business assets are owned by a limited company. All that would be necessary to transfer the assets of a company-owned farming business would be to transfer the ownership of the shares of the corporation.

Certain assets such as livestock cannot be transferred by a farmer to his children on a "rollover" basis if the transfer occurs during the farmer's lifetime. This is discussed in Chapter 16.

The capital gains deduction (see Chapter 13) will not apply to livestock, quota and certain other assets owned by a sole proprietor. However, if the farm is owned by a family farm partnership or a family farm corporation, all of the accrued gain on the partnership interest or the shares of the corporation will be eligible for the capital gains deduction.

iv) Employee benefits are not available

A sole proprietor is a self-employed person, so the fringe benefits applying to an employee are not available to him. Unemployment insurance would not be applicable either but, of course, Canada Pension Plan payments must be made. Self-employed people, farmers included, must pay both halves of the annual C.P.P. contribution.

That, in brief, is a summary of the main advantages and disadvantages of the sole proprietorship or unincorporated farming business. Now we'll turn to another form of organization which involves more than one person.

PARTNERSHIPS

Under pre-1972 tax law, partnerships were not given a great deal of recognition as separate entities for income tax purposes. The income earned by each partner of the business was taxable in the hands of the partner who had earned it, in a similar manner to the income from a sole proprietorship. Under current tax law, however, income for tax purposes must now be calculated primarily at the partnership level and is then allocated to the various partners. Certain expenses which are incurred by the partners in their own right (such as capital cost allowance on an automobile owned personally and used for business purposes) to earn their income from the partnership are deductible by each partner when he fills out his own tax return. It is fair to say that the new rules regarding partnerships have introduced an area of considerable complexity into our tax law. What was a very simple form of business organization for tax purposes is now not nearly so simple. In particular, partnerships which were in existence at January 1, 1972 may require expert advice in order to evaluate their tax position so that unforeseen problems can be avoided.

What is a partnership?

The Income Tax Act does not define what is meant by the term "partnership" but Revenue Canada has issued a statement which sheds some light on the matter:

> "Generally speaking, a partnership is the relationship that subsists between persons carrying on business in common with a view to profit. However, co-ownership of one or more properties not associated with a business (which under Common Law might be a joint tenancy or a tenancy in common) does not of itself create a partnership and this is so regardless of an arrangement to share profits and losses. For guidance on whether a particular arrangement at a particular time constitutes a partnership, reference should be made to the relevant provincial law on the subject and such law will be viewed as persuasive by the Department of National Revenue."

It is very important to know whether or not a particular arrangement between two or more people will be a partnership for tax purposes. As indicated above, the joint ownership of property will not in itself indicate that a partnership exists. However, if two persons own a farm jointly and operate it actively together, sharing the net income or loss produced by the farm, there is a very strong presumption that they are in partnership together. On the other hand a farmer who owns a farm property, but lets another person operate it on a sharecropping basis, such as payment of 20% of the farm's gross receipts, would not be in partnership. Instead, he would be considered to be earning property income as opposed to business income and his sharecropping receipts would be treated in the same manner as rental income. However, under a special tax rule he would be able to use the 5-year block averaging for such rental receipts.

The point which we wish to establish is that it is the facts of each situation which will determine whether or not two or more persons are in partnership. This determination must be made before the income tax consequences of the arrangement can be sorted out.

The advantages of a partnership

i) Participation by two or more persons

Two or more persons can participate in the business. Partnerships between corporations, between individuals and corporations or even between a husband and his wife are also possible.

ii) Choice of fiscal period-end

The partnership may select a fiscal year-end for its business and each partner will then report his income from the partnership on that basis.

iii) Income-averaging methods can be utilized

Income from a farming partnership will retain its character as income from a farming business in the hands of the partner. As a result, block averaging can be used. Use of the cash method of reporting income will also be available as long as all partners follow this approach.

iv) Tax-free rollover of property to a Canadian partnership

Provided certain formalities are observed, it is possible for persons entering into a partnership arrangement to contribute property to the business without incurring an immediate tax cost. An example might be a piece of farm equipment which the partnership will require to carry on its business. If the property were transferred at fair market value a gain might arise which could result in income taxes if the gain exceeds the capital gains deduction that is available. If the property were transferred at its tax value, however, the gain can be deferred until such time as the partnership disposes of the asset.

v) Tax-deferred rollover of partnership interests

The tax-deferred transfer of interests in farming partnerships to descendants is available during the owner's lifetime or at death.

vi) Life-time capital gains deduction on the sale of the partnership interests

Partners will be exempt from tax on the first $500,000 of capital gains arising from the disposition after 1984 of their interests in a family farm partnership (see Chapter 13). This exemption applies whether the disposition occurs during the partner's lifetime or at the time of his death.

vii) Income splitting between husband and wife

A deduction may be claimed for wages paid by the partnership to a partner's wife for employment services rendered to the partnership.

viii) Principal residence

The principal residence status of the family home can be preserved.

ix) Partners' drawings

There are no income tax restrictions on the amount of cash that can be withdrawn from the business. Even if the amount withdrawn exceeds the profit earned, there are no immediate tax problems.

The disadvantages of a partnership

i) No protection from the progressive rates of individual tax

The same comments made in connection with the taxation of income from a sole proprietorship apply here.

ii) No limitation of legal liability

A sole proprietor has no protection from legal action which could be launched against him. A member of a partnership, in most cases, is not only liable for his own actions but is also jointly liable for the actions of his business partners. So choosing a business partner is not something to be entered into lightly!

iii) Additional complexities

A partnership is a more complex arrangement than a sole proprietorship. Additional accounting information will have to be recorded each year so that the partners will be able to determine the tax value of their interests in the partnership.

CORPORATIONS

A corporation is a separate legal person and is treated as such under our federal and provincial laws. The owner of Greendale Farms, for example, may decide to incorporate by selling the assets of his farm business to a limited company which his lawyer has set up for the purpose of carrying on the business. Instead of having just one person involved in the business (the farmer) we now have two (the farmer and the corporation). The corporation carries on the business and the farmer becomes the shareholder and perhaps an employee as well. Depending on the manner in which the corporation is organized and the objectives of the incorporation, the farmer's wife and children may also be shareholders or employees.

As far as the day-to-day operation of the farm is concerned, not a great deal will appear to have changed. The farmer will carry on his farming activities just the same as before. But a closer look will reveal that certain details have changed. For example, purchases and other expenditures will now be made in the name of Greendale Farms Limited rather than Greendale Farms. Sales of farm products will also be made in this name and a bank account will have been opened in the name of the corporation. The annual notice for property taxes will be made out in the name of the corporation instead of the farmer as an individual. All these things are indications to the world at large, and, most important, to the tax collector, that the farming business is now owned by another person -- a corporation named Greendale Farms Limited.

The advantages of a corporation

i) Limited Liability

The exposure of assets to legal action is an important consideration in choosing a form of business organization. If a corporation is used it is only the assets held by the corporation which will be exposed to the risks of the business. Such protection is not afforded by a sole proprietorship or partnership. It is worth noting, however, that it is not uncommon for financial institutions to require an incorporated farmer to issue a personal guarantee in respect of his corporation's bank loans. If that happens, the farmer loses his limited liability - at least in respect of that particular debt.

ii) Ease of transferability

To transfer ownership in an incorporated farming business, all that has to take place is the transfer of shares in the limited company. For an unincorporated business to be transferred, ownership of all the individual assets would have to be changed.

In some situations, the use of a corporation can make it easier for a farmer to achieve his estate planning objectives - particularly where there are several non-farming children. By

setting up the appropriate kinds of shares, it is possible for the farmer to do the following:

- transfer future growth (and some or all of the control) of the farm to his farming children;

- give his non-farming children an interest in the farm that will not allow them to interfere in the running of it; and

- if necessary, retain overall control by holding a special class of non-participating shares which carry the majority of the votes.

This is discussed in more detail in the publication entitled "Estate Planning for the B.C. Farmer" published by the Ministry of Agriculture and Fisheries.

iii) Permanence

Unlike a natural person, a corporation can live forever. It will cease to exist only if it fails and its creditors have its affairs wound up or if it is struck off the register held by the Registrar of Companies in Victoria because statutory requirements have not been met. The corporation could also be done away with if the shareholders decide to liquidate it.

iv) Greater flexibility in tax planning

A corporation which earns taxable income will be subject to tax under rules which are somewhat different from those which apply to the income of unincorporated businesses. It is a fair generalization to state that the use of a corporation will make a farmer's overall tax position more complicated but it also opens up two important avenues which might not otherwise have been available. Very briefly they are:

a) Greater ability to defer taxes on farming income.

If a corporate farm earns more income than the farmer needs to live on, the extra income can be retained in the corporation and reinvested in the farm.

Under current income tax rules this additional income (up to a maximum of $200,000 each year) will be taxed in the corporation at a combined federal-provincial rate (ignoring surtax) of only 23%. As a result of proposals included in the 1986 federal budget, this rate will be reduced to 22% on July 1, 1987 and 21% on July 1, 1988. The present rate of 23% and the lower rates proposed for the future will usually be considerably less than the rates that would have applied had the income been earned by a sole-proprietor or a partner in a partnership. Admittedly, the farmer will probably be subject to a further tax when he withdraws the additional income from the corporation in the form of a dividend, but this tax is deferred until the dividend is actually paid.

It is important to remember that the opportunity for tax deferral arises only if the farmer is able to leave some of his profits in the corporation. If he needs to withdraw all of his profits, there will not be a deferral and the total tax that will be paid by him and the corporation will be approximately equal to what he would have paid if he had remained a sole proprietor.

Commencing in 1983, the federal government introduced a new tax (described as a distribution tax) applicable to dividends paid out of income taxed at the low rate of 23%. This tax, calculated at the rate of 12 1/2% of dividends paid, applied to dividends paid out of such income accumulated in years commencing after 1982.

This tax has been repealed for dividends paid after 1986. Unfortunately, this will not result in overall tax savings to the incorporated farmer because the government has also reduced the dividend tax credit that individuals obtain when they receive dividends from Canadian corporations. The elimination of the distribution tax and the reduction of the dividend tax credit offset each other. The only effect will be that when a company pays a dividend in the future, the tax on that dividend will be paid solely by the shareholder instead of being shared by him and the company.

Because the changes discussed above affect only the tax that is paid when a corporation distributes its income - the fact remains that a farmer can defer tax if he is able to keep a portion of his income in the corporation.

b) Greater ability to split income between husband and wife.

v) Tax-deferred rollover of a property to a corporation

It is possible for a farmer to transfer most of his business assets to a corporation without incurring tax provided the transaction is structured properly. The tax which would otherwise arise is deferred, either in whole or in part. Certain technicalities must be complied with if the rollover is to be obtained, but in most cases the incorporation can be carried out without difficulty.

vi) Choice of fiscal year-end

The year-end for the corporation can be selected in much the same manner as for a sole proprietorship or partnership. Corporations have slightly different rules, however, in that a corporate fiscal year could be 53 weeks long in some cases.

vii) Tax-deferred transfer of shares in the family farm corporation

The shares of a corporation which meets the definition of a family farm corporation will usually qualify for a deferral of income tax

when they pass from one generation to the next. This will apply both during the owner's lifetime and at the date of death. See Chapters 15 and 16 for the rules which apply. An alternative, but more restrictive deferral applies to the end of 1987 provided the corporation qualifies as a small business corporation, rather than a family farm corporation. A farmer will rarely want to use this alternative deferral.

viii) Life-time capital gains deduction

Capital gains realized on the disposition of shares of a family farm corporation are eligible for the lifetime capital gains deduction (see Chapter 13). This applies whether the disposition occurs in the farmer's lifetime or at the time of his death.

In theory, this offers the incorporated farmer an advantage in that the accrued gain on assets such as quota and livestock in effect become eligible for the capital gains deduction by being owned by the corporation and contributing to the value of its shares. In real life, however, it is often more difficult for a farmer to sell the shares of his corporation to a person outside the family because the purchaser wants to buy the individual assets. One potential solution to this problem is for the farmer to hold his land and buildings outside the corporation. The property would continue to be eligible for the capital gains deduction. It would also be eligible for the tax-deferred rollover to children provided it is rented to a family farm corporation for use in its farming business. There may be a reduction in the annual capital cost allowance that is available but this may be acceptable to the farmer.

If a farmer owns land and buildings on which there is a substantial accrued capital gain, he may wish to transfer his farm to a corporation to "lock in" his entitlement to the capital gains deduction on this accrued gain. He will then be protected if at a subsequent time the government decides to withdraw the capital gains deduction. This is discussed further in Chapter 13.

The disadvantages of a corporation

i) Greater start-up costs and on-going administrative costs

The cost of incorporating a limited company, filing annual reports, preparing corporate tax returns and various other legal requirements will add to the cost of carrying on a farming business by means of a corporation.

ii) Loss of five-year block averaging for farming income

The special income-averaging method available for the farming income of a sole proprietor or member of a partnership is not available if the farming income is earned by a corporation. Nor

would salaries paid by the corporation be eligible for such treatment in the hands of the farmer.

iii) Forward-averaging not available

The forward-averaging rules apply to individuals and cannot be used by farm corporations.

TRUSTS AND ESTATES

As a general rule, a farming business would usually be operated by a trust only in situations where the owner of the farm had died and left the business in trust under his will. A practical example might be the situation where a farmer dies leaving a widow and several children. The farm could be left to a trust in such a way that the widow would receive the income of the farming business for the rest of her life. When she died, the farm property would be divided among the surviving children. We will not deal with farms operated by trusts and estates in any detail here since their income tax treatment can become quite involved and warrants a separate study in itself. On the whole, the average farmer will not find the use of a trust a convenient form of organization through which to carry on his farming activities. Trusts may be useful, however, in some of the more sophisticated and complex tax planning arrangements.

QUESTIONS TO CONSIDER WHEN SELECTING THE FORM OF BUSINESS ORGANIZATION

Now that we have examined the forms of business organization, let us outline some of the practical questions a farmer should ask himself in arriving at a wise choice as to his form of organization. Some of the most important questions which should be answered include the following:

1. What is the expected level of annual farm income, at present and in the future?

This is a key factor in determining whether or not it is advantageous to use a corporation. As mentioned previously, there is an opportunity to defer income taxes but the benefit arising from this deferral will depend on the extent to which the farm generates income in excess of the needs of the operator of the farm. If the operator needs all of the income generated by the farm there will be no deferral of tax because the income earned by the corporation will be fully distributed each year in the form of salaries or dividends.

2. What will be the ultimate disposition of the farm property?

This is perhaps even more important than the first point. Our federal income tax law permits a farmer to transfer land, certain depreciable property and eligible capital property (such as quota) used in a farming business to his descendants without any immediate tax liability. The transfer can be made during the farmer's lifetime or, on his death, under his will. As long as the farm property is used by the family in the business of farming it can pass indefinitely from one generation to the next with no tax arising.

There is an even broader rollover available in respect of an interest in a family farm partnership or shares of a family farm corporation. Using these forms of business organization it is possible for a farmer to transfer livestock to his children on a tax-deferred basis during his lifetime. This is not possible if the farmer carries on his business as a proprietorship. A farmer who is a sole proprietor can, however, transfer his livestock to his children on a rollover basis on his death (see Chapter 15).

As mentioned previously there is, in theory, an increased ability to take advantage of the capital gains deduction if the farm is owned by a family farm partnership or family farm corporation because the deduction can, in effect, apply to the accrued gains on livestock and quota owned by partnership or corporation.

3. Are other members of the family involved in the farming operation: What is their relationship to the farmer?

This question is important in allocating the annual income produced by the farm and also from an estate planning viewpoint. If two brothers and their families operate a large farm, for example, it might be advantageous for each family to have a corporation and for those corporations to form a partnership to operate the farm. Each family will then have a corporation which can be used to their advantage for estate planning purposes and what is done by one family will not directly affect the actions or plans of the other.

4. What types of assets does the farmer own?

When planning the type of organization to use, consideration must be given to the types of assets which the farmer owns. Because different assets receive different tax treatment it may be desirable to hold certain assets personally and other assets through a partnership or corporation. (The family home, for example, should be owned personally to ensure that the owner can use the principal residence exemption.)

5. Who will inherit the farm?

In some situations, a major factor in determining the appropriate business organization will be the manner in which it will facilitate the transfer of the farm to the farmer's children. If there are a number of children, some of whom are not working on the farm, a corporation may make it easier for the farm to treat all of his children equitably while allowing his farming children to continue to run the farm.

6. Is there a large accrued capital gain on land and buildings owned by the farmer?

If there is a large accrued capital gain, perhaps the farmer should consider incorporating to "lock-in" his entitlement to the capital gains deduction. There are always rumours to the effect that the capital gains deduction will be eliminated or curtailed so this will protect the farmer's position. Extreme care would have to be taken to ensure that the farmer is not subject to the new alternative minimum tax (see Chapter 14).

7. Is the farmer willing to complicate his affairs to minimize taxes?

To what extent is the farmer willing to disrupt his present situation, and possibly make it more complicated, in the interests of reducing his tax burden? Will such changes be worth the cost? This is perhaps the most important question of all. No changes in farm organization should ever be made purely in the pursuit of tax savings. The practical consequences of reorganization must be considered first. Often an accountant or lawyer will suggest a change which could reduce a farmer's tax burden but the farmer will be reluctant to depart from the tried and true approach with which he is familiar. Such a position on the farmer's part must be respected. On the other hand, some farmers may be very aggressive in seeking out new ways in which they can reduce their income taxes, during their lifetime and at time of death. The great majority of people probably fall somewhere between these two extremes. The point of this discussion is simply that the farmer and his professional advisors should both have a clear idea of what changes are practical and whether the farmer's best interests are served by making them.

The Ministry of Agriculture and Fisheries booklets, "Farm Business Partnerships in British Columbia", "Farm Business Corporations in British Columbia" and "Estate Planning for the B.C. Farmer" should prove useful to farmers who wish to further pursue the ramifications of these forms of organization.

Chapter 3

WHAT YOU SHOULD KNOW ABOUT THE CASH METHOD OF ACCOUNTING

What is the cash method?

If you are a person who is already in the business of farming you probably have been using this method to report your farm income since you began. It is basically very simple. You include in your income only those amounts you have actually received in the year and you take as deductions only those expenses which were actually paid for in the year. In addition you claim capital cost allowance, an income tax term for depreciation expense, up to the prescribed maximum amounts allowable for the various classes of depreciable assets which you own. No accounting has to be made for inventories or accounts receivable and no deduction can be taken for any unpaid bills which you might happen to have on hand at the end of the fiscal year.

There is another aspect to the cash method, however, which is of special importance to farmers who have inventories of livestock - the livestock inventory provision.

Livestock is not defined in the Act but it will be interpreted to include at least cattle, horses, sheep and swine. Revenue Canada has indicated that other forms of livestock may qualify as well for purposes of this rule. Poultry, fur bearing animals, bees and virtually any other living creatures maintained and bred as part of a farming operation will be considered to be livestock.

Many farmers seem to be unaware of this important rule regarding livestock inventories so it is well-worth reviewing it in some detail. Essentially, this provision allows a farmer to include in his farming income for the year any amount up to the fair market value of his livestock, other than basic herd animals, owned at the end of the year. Here is an illustration:

Assume that farming is this person's only source of income.

Farm receipts for the year	$ 86,000
Farm expenditures for the year, including cattle purchases of $12,000	88,000
Cash loss from farming operations	$ (2,000)
Value of livestock, other than basic herd animals, at year end	$ 25,000

The farmer in this case is building up his herd. If he had not bought any livestock in the year he would have netted a $10,000 profit. However, because the cost of these animals was deductible, he now shows a loss of $2,000. If he wishes, the farmer can take any amount (from $1 to $25,000) and add it to the income he is reporting. In other words, he has a choice of reporting as the final figure on his tax return any amount from a loss of $2,000 to income of $23,000. The amount of the inventory value which he adds to income in one year must be deducted from the income he reports in the following year.

But wait a minute, you might say. What advantage is there to doing that? Won't this just put him in a position where he will have to pay income tax? Perhaps, but consider these reasons:

a) If a farmer who is building up his herd over a period of years incurs losses for more than ten years (five years for losses incurred before 1983), he will lose the chance to deduct these losses against future income. His 1986 loss, for example, must be deducted from income by 1996 or it is gone forever. By placing a value on his livestock inventory which will reduce each year's loss to nil, a farmer can avoid this time restriction on using his tax losses. The losses are, in effect, converted into inventory values which can be carried forward indefinitely (provided the farmer continues to own the herd) and can be deducted in any year in which the farmer makes a profit.

   A person in the business of farming who has pre-1983 losses which are in danger of expiring due to the five year time limit should seriously consider using his year-end inventory value to offset these loss carryforwards.

b) Another important consideration is to ensure where possible, that the farmer utilizes the personal exemptions available to him. Assume a farmer has personal exemptions totalling $8,000 for 1986 for himself and his family. If he does not use these personal exemptions by offsetting them against income, then he loses them altogether. Unused personal exemptions can never be carried forward to the next year. The farmer in our example can avoid this hardship simply by adding to his income $10,000 in respect of his ending livestock inventory. His net income from the farming business will then be changed from a loss of $2,000 to a profit of $8,000. His taxable income will be nil and he will have no tax to pay but he will have preserved $10,000 of deductions for a time in the future when he has cash income which is subject to tax.

c) In years prior to 1986 there was a minimum level of taxable income which was exempt from both federal and British Columbia income tax. The use of the livestock inventory rule was very helpful in setting taxable income at an amount which was exactly equal to the level of income which could be received tax-free. This deminimis level of taxable income was just like another personal exemption in many respects.

d) Under the Canada Pension Plan, persons such as farmers who are self-employed were required to contribute up to a maximum of $838.80 in

1986. This maximum contribution level was based on a maximum of $25,800 self-employed earnings in the year. If you earned less than $25,800 in 1986 then your contribution was also less. A farmer who reports a loss does not make any C.P.P. contributions. Keep in mind, though, that the benefits a person (or his dependents) will eventually receive from our national pension scheme are based strictly on the amount of the contributions which he has made. If there are no contributions, there are no benefits either. For this reason, a farmer may wish to ensure that he reports net self-employment earnings each year which are at least equal to the C.P.P. maximum earnings. This will ensure that the maximum benefit will be paid when the farmer ceases to pay in and starts to collect instead. The amount of the maximum earnings has been increasing in recent years so in planning the amount of your farming income you should always check to see what the C.P.P. maximum earnings is for the current year. Your income tax form or T1 guide will have this information.

(e) Contributions to registered retirement savings plans are also governed by the level of the contributor's earnings. The maximum annual contribution in 1986 and 1987 is generally the lesser of $7,500 and 20% of the contributor's "earned income" (which includes farming profits). On this basis, a farmer will be able to make the maximum contribution to his plan if his farming income is $37,500 or higher.

We have mentioned only five reasons why a farmer who produces and sells livestock might wish to adjust the level of his income for tax purposes by taking in a portion of the value of his year-end inventory. In particular situations, there may be other reasons as well.

If tax returns for prior years have been filed without using this livestock adjustment the farmer should ask Revenue Canada for permission to revise the years which are still open for reassessment so as to at least claim personal exemptions and eliminate losses. Legally Revenue Canada can refuse this request but they do permit adjustments in some situations. There is nothing to be lost by trying.

We should also mention that the amount of capital cost allowance which is deductible by a farmer can be varied within limits and this too can be used to adjust income to the desired level. This technique is available to all taxpayers, however, not only farmers.

Who can use the cash method?

According to the income tax rules dealing with the computation of business income, only persons who have income from a farming or fishing business can use the cash method. The word "person" in this context includes individuals, corporations, partnerships and trusts.

Once a person commences to use the cash method he must continue using it in the future. Permission to switch to the accrual method, the basis used by virtually all other taxpayers who earn business income, must be obtained from the tax authorities. If two or more persons operate a farm jointly they each

must use the same method to report their farming income.

Interestingly enough, permission does not have to be obtained by a farmer who wants to switch from the accrual method to the cash method. All that is required is to begin filing tax returns using the cash method, ensuring that all proper accounting adjustments have been made.

So much for the cash method of accounting. It provides a great deal of flexibility in determining taxable income. Farmers should take maximum advantage of it!

Chapter 4

VALUATION OF A FARMER'S PROPERTY

A. What you should know

The most significant change brought about by Canada's 1971 tax reform was the introduction of tax on capital gains. Virtually every Canadian who owns property was affected by this broadening of the tax base. For most Canadians, the tax base has now been narrowed again by the new lifetime capital gains deduction. However, because this deduction is limited (see Chapter 13) and there is the possibility that a large capital gain will bring the new "Alternative Minimum Tax" rules into play (see Chapter 14), the measurement of capital gains continues to be important.

Since 1971, Canadians have gradually become accustomed to using the phrase "valuation day" or simply "V-day" to describe the day from which the capital gains on property owned before 1972 are measured. Essentially capital gains realized after 1971 from the disposition of property owned before 1972, will be taken into account for tax purposes only to the extent that such gains exceed the gain that accrued prior to V-day. If there is a post 1971 gain, only one-half (described as the taxable capital gain) is subject to tax. Of course, there are similar rules dealing with capital losses. Only one-half of post 1971 losses (described as allowable capital losses) are deductible from income.

Taxpayers (including partners in a partnership) may deduct their allowable capital losses from taxable capital gains realized in the same year. To the extent they are not utilized they may generally be carried back three years and carried forward indefinitely. Individuals who are carrying forward net capital losses which were incurred prior to May 23, 1985 may deduct up to $2,000 of such losses from their other income each year. There are certain capital losses called allowable business investment losses which may be carried forward for seven years and applied against any type of income. If these losses are not used in that seven year period, they become ordinary capital losses and may be carried forward indefinitely to be applied against capital gains.

The amount of the capital gain that an individual (or a partner in a partnership) will realize as a result of selling a property owned prior to 1972, may vary depending on whether the individual uses the "neutral zone method" or the "V-day method" of computing his capital gains and losses. These two methods are often referred to as the "transitional rules". The V-day method can be used only if an election is filed with the tax return for the first year in which a pre-1972 property was sold at a profit. Having selected the V-day method for the first pre-1972 property sold, it must be used for all pre-1972 properties. If the V-day method election is not filed, the neutral zone rules apply automatically.

Setting aside the transitional rules, the immediate implications of a tax on capital gains are fairly simple. If you owned capital property at V-day or acquired property after that date, it is almost certain that at some point you will dispose of that property for proceeds which are either greater or

less than V-day value or cost. The resulting capital gain or loss may result in a tax cost (depending on the availability of the capital gains deduction) or tax saving when your tax return is filed for the year in which the disposition is made.

What is capital property?

Capital property includes, under normal circumstances, the following types of assets which a farmer might own:

a) Farm land and improvements such as drainage and fences
b) Buildings
c) Machinery, equipment, vehicles
d) Farm homes
e) Stocks, bonds and other securities
f) Personal use property such as boats, summer cottages, automobiles
g) Certain items specified as listed personal property: coins, stamps, rare books, jewelry, drawings, paintings or sculpture.

If a farmer owned any of these types of assets at the end of 1971 he will have to determine their V-day values. This applies irrespective of which transitional rule he decides to use. He will also have to determine the V-day value of the following properties which he owned at the end of 1971:

a) Basic herds
b) Milk quotas or other government rights or licences of this nature.

Farmers who have acquired capital property since V-day are required to maintain accurate cost records.

What is a disposition of capital property?

Obviously, it includes the sale of property to someone else, but it also includes a lot of other transactions as well. You should be aware that a disposition will occur (and all the capital gains rules will apply) when the following events occur:

a) Property is sold;
b) Property is gifted;
c) The owner of the property dies;
d) Property is taken unlawfully;
e) Property is expropriated;
f) Property is destroyed and insurance proceeds are received;
g) Property is transferred to a trust, corporation or partnership;
h) A marriage breakdown occurs and a division of property is made pursuant to the Family Relations Act.

Again, our list is not a complete one but it covers most of the more common situations. A disposition of capital property is deemed to occur immediately prior to a person's death so that, in all cases, there must be a disposition of some kind in the lifetime of every individual who owns capital property. Farmers, as we shall see later, receive special consideration on the

disposition of farming assets to their children in that they can arrange for the transfer to take place on a "rollover" (tax-deferred) basis. The existence of this special treatment does not eliminate the need for a V-day valuation because the effect of the "rollover" is only to postpone taxes, not to forgive them.

Of course, farmers now have the capital gains deduction and, unlike other taxpayers, they are entitled to the full deduction immediately if they realize a capital gain from the disposition of qualified property (see Chapter 13). However even this development does not remove the necessity of obtaining a V-day value. Farmers still need to calculate their capital gains so that they can determine if their capital gains deduction will cover them. They also need to determine if the new alternative minimum tax rules apply (see Chapter 14).

B. Why you should establish your V-day value NOW

First, it is necessary to be aware of the significance that valuation day values and cost records have in determining a person's tax liability. There is a tendency to put off determining these values since there is no need to report them to the tax authorities until a disposition of the property takes place. And that might not be for years and years. But the time to establish a V-day value is as near as possible after V-day because the difficulty of doing it grows with the passing years. Consider these factors:

a) Inflation. Farm asset values have risen since V-day and will probably continue to do so. For some assets, such as real estate, values are changing constantly. Establishing what the value was at a particular time becomes more difficult if values are subject to changes in local conditions.

b) Documentation. Documentation which can provide support for asset values at December 31, 1971 is still available but as time goes on this sort of evidence, such as news articles, advertised prices for assets similar to yours etc., becomes much more difficult to obtain. Consider, for example, the list prices and trade-in values for farm machinery.

c) Photographs. These may be important to portray the condition of an asset at or near valuation day. Pictures can be of great assistance in cases where an asset changes over a period of years. An example might be a parcel of land adjacent to a deep gully in which serious erosion was taking place. The land might have had considerable value at V-day but be virtually useless as farm land at the date of disposition many years later due to the erosion. A photograph taken near V-day could provide excellent support for a higher V-day value.

d) Information regarding neighbouring properties. This can be very useful. Keeping a record of nearby properties or properties similar to your own in the same area, and what they sold for, provides important guidelines for the value of your own property. It is much easier to compile this information if you do it now instead of many years in the future.

e) Knowledgeable persons who can provide information or opinions. Who knows more about his farm than the farmer himself? But if he dies without leaving behind the benefit of his knowledge in writing then the value of his intimate knowledge of the farm will be lost. Persons with a working knowledge of real property values in your area at December 31, 1971 also pass from the scene. Getting a letter of opinion from them now might be something which is not possible when the need for the letter arises.

f) Getting an appraisal. The foregoing comments apply to farmers who wish to establish their own V-day values themselves rather than having a formal appraisal done by a professional appraiser. Appraisals cost money but are important in cases where the farmer's property is substantial in value. Farmers with property whose V-day value is significant might be well advised to get a formal appraisal. The appraiser's job is a difficult one, but it will never be any easier than it is now.

g) Estate settlement. The handling of a person's estate will be considerably expedited if the deceased person has V-day values on hand for all his capital property. It is something that should be taken almost as seriously as making a will.

A special note regarding rollovers of various forms of farm property

The rules regarding rollovers for farm property are discussed in Chapters 15 and 16. The general concept of the rollover provisions is that the recognition of a capital gain or the recapture of capital cost allowance is deferred. Tax will not be payable until the farm property ceases to be passed from one generation to the next. It is possible that a family farm, family farm corporation or an interest in a family farm partnership could be handed down from father to son for a hundred years before there is a taxable disposition. Who will be around in the year 2086 to say what the property was worth on December 31, 1971? Do yourself and your family a favour by taking steps NOW to establish V-day values for your property. Having done that, put the valuation in a safe place and make sure your family knows where it is.

C. How should you go about determining valuation day values?

A farmer can either call in a professional appraiser to do the job or he can do it himself. The cost of getting an appraisal could amount to several hundreds or thousands of dollars and farmers should be aware that such an expenditure is not deductible as a business expense. Nor can it be used to reduce the amount of the capital gain which will ultimately arise when the property is disposed of. Nevertheless, a professional appraisal can be most worthwhile and it is probably the strongest ammunition a taxpayer can have in defending his V-day value if it should be disputed by Revenue Canada.

If you decide to carry out your own valuation you may have a major job on your hands but there is no reason why a farmer cannot do it. After all, your knowledge of the farm assets is probably more detailed than anyone else's. Setting up a good file on V-day documentation to support the values for

various farm assets is a major topic for discussion itself.

We recommend that you obtain a copy of a helpful instruction guide on farm valuation published by the British Columbia Ministry of Agriculture and Fisheries called "Valuation of British Columbia Farm Assets for Capital Gains Tax". This publication will be useful in a do-it-yourself appraisal and in assembling information for a professional valuator.

A final note on valuation of farm property

A natural question for a person to ask is, how are the tax authorities going to know what my farm was worth at V-day? Revenue Canada maintains a staff of people who are expert in the field of appraisals and business valuation. They can compile detailed information on comparable real estate transactions which took place close to V-day. This information will be available to assist a tax auditor in determining whether or not the farmer's V-day value is reasonable.

If you do not do a proper V-day valuation and support it with appropriate documentation, or have one done by an appraiser, you may be forced to accept Revenue Canada's value which may not be as accurate or as advantageous as the one which a farmer could obtain.

We are many years away from valuation day already. Don't let another year go by without looking into the important task of determining the value of your farm as of December 31, 1971.

Chapter 5

WHAT YOU SHOULD KNOW ABOUT INCOME AVERAGING

What is it and what purpose does it serve?

Income averaging is a term applied to any system which evens out income over a period of years. It is beneficial to taxpayers because individual tax rates are based on a sliding scale. The more income you have in any one year, the greater the percentage that must be paid to the tax collector. A resident of British Columbia who has taxable income of $10,000 in 1986, for example, pays tax at an approximate rate of 27% on his last dollar of income. This rate is described as being his marginal rate of tax. If his income increases to $40,000 then his marginal rate of tax increases to approximately 43%. These rates do not take into account the federal and provincial surtaxes.

The federal government has recognized that certain groups of taxpayers, including farmers, can be penalized by this system because the cyclical nature of their business sometimes causes a considerable fluctuation in their incomes from one year to the next. As a result, these taxpayers have been able to average their income under special rules in the Income Tax Act.

What are the various kinds available?

In the past, three different averaging techniques were available to the farmer. Unfortunately, two of these (general averaging and the purchase of income-averaging annuity contracts) have been removed from the Income Tax Act and have been replaced by an averaging mechanism which is not as beneficial. The commonly-used methods of averaging which are available now are as follows:

a) Five-year block averaging

It can be used by all individuals whose chief source of income was farming throughout the five-year period. The "Farmer's Income Tax Guide" gives an excellent summary and illustration of five-year block averaging. Keep in mind that the chief source of a person's income is a question of fact, based on individual circumstances, and will be determined separately for each year in the averaging period.

b) Forward averaging

This form of averaging was put into the Income Tax Act in 1982 and is available to all individual taxpayers. Unfortunately, because of the manner in which the averaging works, it will generally only be useful to individuals taxed at the highest rates.

A farmer will be able to use forward averaging in a particular year if his net income in that year is greater than the average of his "adjusted net incomes" for the previous three years. The "adjusted net incomes" will be the incomes as reported on the farmer's tax returns, adjusted by an inflation factor.

A farmer is also able to "forward average" to the extent that his income includes taxable capital gains arising from a reduction in the year of "capital gains reserves". A "capital gains reserve" is available when capital property is sold and the proceeds are payable over a number of years.

Any income that a farmer decides to "forward average" (which cannot be less than $1,000) is taxed in the year of averaging at the top marginal rate. For a resident of B.C. in 1986, this rate (excluding surtax) is approximately 50%. This initial 50% tax is an "interim tax" that is potentially refundable in later years.

In years subsequent to the year of averaging, the farmer must decide whether any of the "averaged income" should be included in his tax return. Any amount that is so included will be taxed at the rates prevailing in those years and the farmer will receive a credit for a portion of the 50% tax that was paid in the year of averaging (adjusted for inflation).

Because "averaged-income" is taxed at the top marginal rate, this averaging method will generally be used only by those farmers who have an unusually high income in a particular year or are taxed at the top rate.

What does a person have to do to take advantage of income averaging?

a) Five-year block averaging

Nothing has to be done until you file your income tax return in the fifth year of averaging. But you must have filed your returns on time for the previous four years and your chief source of income must have been farming for each of the five years included in the averaging period. Form T2011 must be completed and filed with your return. Note that a tax return for any nil income year can still be technically filed on time if it is sent in at the same time as the tax return for the year the block averaging calculation is utilized.

It is important to note that a block averaging election cannot be made in a year if forward averaging has been used in that year or in any other year in the averaging period.

It is also important to be aware that the new minimum tax rules will not apply in any year in which a block averaging election is made.

b) Forward averaging

Again, nothing need be done until you file your income tax return for the year in which you want to "forward average" or the year in which you want to include some of the averaged income in your tax return. Revenue Canada has issued a special election form (T540) which must be completed and filed with your tax return. This is not an

automatic averaging mechanism (like general averaging was), so Revenue Canada will not apply the averaging rules unless you prepare form T540 and complete your tax return accordingly.

A forward averaging election will be invalid for a particular year if tax returns for the preceding three years are not filed by the date on which the tax return is due for the year of averaging. If, in any of the previous three years, no tax was payable it is only necessary for you to file a prescribed form.

Which method of averaging will be most beneficial?

The response to this question depends entirely on the specific situation. It depends on the amount of money involved, a person's individual circumstances, the level of his income in the past years and his expectations for the future. Sitting down with your tax advisor to discuss which way you should go with income averaging is time well invested. It could save you a considerable amount of tax.

Chapter 6

THE TAX TREATMENT OF BASIC HERD AND OTHER FARMING INVENTORIES

In this chapter we will discuss briefly how our federal income tax law deals with livestock inventories, crop inventories, and other inventory items.

A. Livestock inventories

We will deal with these assets under three separate headings: basic herds, the constant unit value election and non-basic herd livestock. As time goes on, and our tax system matures, tax problems involving basic herds will gradually disappear and questions regarding the other methods of accounting for livestock will replace them. However, basic herds will be around for some time yet so it is important to understand the rules.

Basic herds

These were part of the tax system before 1972 and applied to certain specified groups of animals (cattle, horses, sheep or swine) owned by a farmer. Once a basic herd of a class of animals was established for income tax purposes the cost of additions to the basic herd was not deductible and the proceeds from reductions of the basic herd were not taxable. In other words, the herd was recognized as a capital asset of the farmer or rancher in somewhat the same way that plant and equipment are capital assets to a manufacturing business. It is interesting to note that the basic herd concept was not authorized by law under the pre-1972 tax system but was strictly the result of the practice of the tax authorities. In the law now, however, basic herds are defined but they are also being done away with! No new basic herds can be established now nor can existing ones be increased. Special transitional rules have been allowed to carry over into the new tax system.

Simply stated, the transitional rules provide two different ways in which this phasing-out of existing basic herds will be accomplished; the mandatory reduction and the optional reduction.

The mandatory reduction

As a general rule, if the number of animals in the herd at the end of a taxation year is less than the approved basic herd number, the farmer's approved basic herd must be reduced to the lower figure. The farmer must then take a deduction from his income representing the amount of the reduction which has occurred in his herd. The formula would be:

Deduction from income for basic herd reduction	=	number of animals by which herd was reduced	x	average of the fair market value of all the animals in that class at December 31, 1971

If a farmer with a basic herd wishes to ensure that he is not affected by this mandatory reduction in his basic herd he should ensure that, at the end of the year, the number of animals in that class is not less than the number of animals in his approved basic herd for that class of animal. If this is done each year the basic herd can be continued indefinitely.

Optional reduction

If a farmer does not have a decrease in his herd which brings the mandatory reduction into effect, he still has the choice of using the optional reduction. These rules allow a farmer to write off each year for tax purposes a maximum of one-tenth of the December 31, 1971 fair market value of his basic herd. In fact, though, the amount of the allowable deduction may be less than that since it cannot exceed the least of three amounts:

a) the number of animals of the class disposed of in the year;
b) 10% of the basic herd at December 31, 1971; and
c) the number of animals in the basic herd at the end of the preceding year.

Farmers should note that where a write-off of 10% of the basic herd is available, it does not have to be taken in full. Any amount less than 10% could be taken for the year. The same principle applies here as applies to cash basis farmers with livestock inventories which do not qualify as basic herds (see Chapter 3). A farmer might need to take only a 5% write-off, for example, to reduce his taxable income to nil. Or in a year of relatively low income he might prefer not to take any write-off and save the deduction until future years when profits are higher.

These are the tax principles which apply in the phasing-out of basic herds. Several years ago, Revenue Canada issued an excellent summary of the basic herd rules, together with illustrative examples. This booklet is entitled "Basic Herds" and can be obtained on request from your District Taxation Office. Every farmer who accounts for any of his livestock on this basis should have a copy of this publication to guide him as to the tax treatment of his purchases and sales.

V-Day values

If you have not yet established the December 31, 1971 market value for your basic herd then it would be wise to do so as soon as possible. As in the case of other V-Day valuations, the higher the value assigned to the animals the greater the advantage when the animals are disposed of. But the values must be reasonable to be accepted by the tax authorities.

What happens to the herd if a farmer dies or goes out of business?

Suppose that at the time of a farmer's death his livestock herd has a fair market value of $150,000 and the dollar amount of his basic herd at December 31, 1971 which had not yet been written off for tax purposes was $80,000. In the final income tax return of the farmer the $150,000 must be shown as income (unless the herd passes to the farmer's heirs within a certain time limit - see below) but this will be partially offset by the deduction of the $80,000.

Legal representatives who look after the deceased farmer's affairs should be aware that a separate tax return can be filed to report a cash basis herd and a second set of personal exemptions can be claimed on this return.

As an alternative, the legal representative may, within certain time limits, transfer the ownership of the herd to the widow or children who are the beneficiaries of the estate. If this is done, the value of the herd is taxable in the hands of the beneficiary who inherits the livestock, but not until the herd is sold in the ordinary course of events.

If the deceased farmer has a basic herd which has not been written off for tax purposes, the legal representatives should ensure that a sufficient portion of the herd's value is included in income in the year of death so as to absorb the deduction for the basic herd. Care must be taken in the manner in which this is done. A beneficiary who inherits basic herd animals will not be permitted to carry on with the basic herd concept.

When a farmer goes out of business and sells his herd, he will be able to deduct the 1971 value of his basic herd which has not yet been written off for tax purposes and the full amount of proceeds from the sale will be brought into income as it is received.

Miscellaneous comments on basic herds

There are some additional points that we would like to make regarding basic herds. The first point, already mentioned but worth repeating, is that even though the basic herd is treated like a capital asset, increases in the value of the animals are not treated as capital gains (one-half taxable) but as ordinary income (fully taxable). Secondly, basic herds were available under the pre-1972 tax system not only to cash basis farmers but also to farmers who used the accrual method of accounting. This practice is continued under the present rules and Revenue Canada's booklet shows how the calculations would be made. Farming corporations, provided they had established their basic herds by the date their 1971 income tax returns had to be filed, are also entitled to use the basic herd rules in the same manner as individual farmers.

The constant unit value election for farmers who are not on the cash basis

Under the present tax system, farmers are entitled to use the accrual method of accounting, under which inventory values must be taken into account, or the cash method under which inventory values can be ignored. Most farmers are probably using the cash method because of its advantages (see Chapter 3) but there may be some farmers who, for various reasons, choose to use the accrual method of accounting. In a period when the value of livestock is rising it is possible that profits calculated on this basis may be high purely as a result of the value of a farmer's inventory. It is conceivable that a farmer could show a profit on which he has to pay tax but have no cash with which to pay such taxes since his profit for the year is largely represented by an unrealized increase in the value of inventory. In recognition of this type of problem, the government has provided a special election for farmers who report income on the accrual basis. This election

enables them to report their inventory at values which remain level from one year to the next. The result is that the ups and downs of the livestock values in inventory are removed and the farmer's profit can be closer to his cash intake for the year.

The election is available to any person in the business of breeding and raising animals but may not be used with respect to registered animals, feedlot operations or animals bought for resale. The election is made by filing special form T2034 with your income tax return for the year in which the constant unit value is adopted.

Non-basic herd livestock inventories

This subject has already been covered under our comments on the cash method (Chapter 3) where we discussed the special choices available to farmers who own livestock inventory other than basic herd animals. We will not repeat those rules here except to reiterate the principle that, under the cash method, all purchases of livestock in the year can be deducted in computing income and all sales proceeds received must be included in income.

For farmers on the accrual basis, the inventory of livestock is accounted for using the same principles which apply to the inventory of any other type of business. An exception to this rule is the constant unit value election which we mentioned above.

B. Crops and other inventories

As with livestock, inventories of crops or other items can be ignored by cash method farmers but must be accounted for by accrual method farmers. These inventory items could include such things as hay, grain, feed pellets, seed, fertilizer, fencing wire and posts, and other supplies of any kind. The methods of accounting for inventory which are acceptable under the income tax rules are spelled out in the "Farmer's Income Tax Guide".

The principles and options discussed above which apply to a farmer's livestock inventory when he dies or goes out of business also apply to his crop and other inventories.

We should remind British Columbia grain farmers of the possible use of the deferred cash purchase ticket as a means by which crop inventories can be sold but proceeds are not taxable until the subsequent year. Grain delivered to either a primary or process elevator may qualify. The use of these tickets is described in the "Farmer's Income Tax Guide":

> "When you deliver grain to a licensed public elevator or process elevator, you may receive a storage ticket, a cash purchase ticket or a deferred cash purchase ticket. If a storage ticket is issued, no sale has taken place and, therefore, you have not received income at that time. If a cash ticket is issued, a sale has taken place and you are considered to have received payment at that time, regardless of when the ticket is presented for payment. If a deferred cash purchase ticket is issued, and the ticket provides

for payment at a date that is after the end of the fiscal period in which the grain is delivered for sale, you must report the purchase price stated in the ticket as income in the immediately following fiscal period. The deferral of income is only available in certain circumstances which are explained in Interpretation Bulletin IT-184R entitled "Deferred Cash Purchase Tickets Issued for Grain".

The use of a deferred cash purchase ticket might enable a grain farmer to sell his grain, thus taking advantage of the price prevailing at a particular point in time, while deferring the income for tax purposes until a subsequent tax year.

Chapter 7

DEPRECIABLE ASSETS USED IN THE BUSINESS OF FARMING

Most persons in the farming business are aware that the cost of assets of a long-lasting nature, such as machinery, equipment, vehicles and buildings, cannot be deducted for tax purposes as an expense. Instead, the expenditures are considered to be of a capital nature and the cost must be deducted from income over a period of years by claiming a special deduction based on the cost of the assets. The methods by which this deduction (the tax term is "capital cost allowance") must be calculated are set out in the regulations to the Income Tax Act.

Under the pre-1972 income tax system, farmers could choose between two different methods of calculating capital cost allowance:

a) the straight-line (Part XVII) method, and
b) the declining balance (Part XI) method

Under the present law the straight-line method is being phased out. No asset purchases after December 31, 1971 can be written off on this basis. However, assets which were owned at December 31, 1971, provided they have never been written off on the declining balance basis, may be depreciated on the straight-line basis as long as the farmer remains in the business of farming. He may, of course, at any time transfer the undepreciated cost of a straight-line asset into a prescribed asset class under the declining balance basis. But once this decision is made it is irreversible. As in the elimination of basic herds, the phasing out of straight-line capital cost allowance will be a gradual process which will probably take a number of years to accomplish.

The mechanical rules for the two methods are familiar to most farmers and are adequately explained in the "Farmer's Income Tax Guide" so it is not necessary to repeat them in detail here. It is appropriate, however, to provide a summary of some of the major similarities and differences. This listing may assist a farmer to decide whether or not he should continue on the straight-line basis or switch over to the declining balance method.

a) There is flexibility as to the amount of annual deductions under both methods.

b) There are higher write-offs in the initial years under the declining method.

c) No capital cost allowance in the year of sale on a declining balance asset but a prorated amount on a straight-line asset.

d) No recapture or terminal loss of capital cost allowance on the sale of straight-line assets.

e) Capital gains may arise under both methods but capital losses do not arise under either.

f) No tax when depreciable assets are transferred to a spouse or left to a spouse under a will.

g) Declining balance assets may be transferred to a child at their tax value whereas straight-line assets can only be transferred at their fair market value.

As a general rule, it will be preferable for most farmers to stay with the straight-line method wherever they can and to use the declining balance method for only those assets which they acquired after 1971. If you decide to take the simpler approach and switch all of your assets to the declining balance basis, the "Farmer's Income Tax Guide" has a good outline of the procedures to follow in making the change in your tax return.

Recapture of capital cost allowance/terminal losses

Under the declining balance system, expenditures for depreciable properties are added to the appropriate capital cost allowance class and depreciation is claimed on the balance in that class at the end of the farmer's fiscal period. If the farmer disposes of any property, the sale proceeds (up to the property's original cost) is deducted from the undepreciated balance in the appropriate class and the farmer depreciates the net amount. If the proceeds exceed the undepreciated balance in the class (after taking into account the additions to that class in the year of sale) the excess is generally included in the farmer's income as recaptured depreciation.

If a farmer disposes of property depreciated under the straight-line system and the proceeds exceed the depreciated value of the asset, the depreciation claimed in previous years is not recaptured. Of course, if the proceeds exceed the higher of the original cost or the value at the end of 1971, the excess will be treated as a capital gain and one-half will be subject to tax.

If a farmer disposes of all property in a declining balance class and there is an undepreciated balance in that class, the amount may generally be written off as a terminal loss.

Where a person transfers Part XI depreciable property to a partnership or to a corporation that he controls (as defined), there are provisions in the Income Tax Act which prevent him from deducting the terminal loss that would otherwise arise. These provisions apply to individuals, partnerships and corporations. There are also rules that will restrict the deduction of a terminal loss arising on the sale of a building in situations where the land on which the building is situated is sold at a profit. These new rules require taxpayers to net the terminal loss against the capital gain arising on the land.

Government incentive through special capital cost allowance rates for certain assets

Sometimes, as a means of encouraging a certain type of economic activity, the federal government increases the write-offs available on certain kinds of assets. These special write-offs normally have a limited life and their

availability usually depends on the particular time period in which the asset was purchased. The incentives are available only for declining balance assets.

Two examples of increased write-offs which are of particular interest to certain British Columbia farmers are the rates applying to buildings used for storing fresh fruit and vegetables, and buildings used for preserving ensilage. Buildings acquired after February 19, 1973 that are used for these purposes will be eligible for a write-off rate of 20% per annum instead of the regular 5%.

There may also be cases where certain depreciable assets acquired primarily for the purpose of pollution control will qualify for rapid write-off. Information is available in the "Farmer's Income Tax Guide."

Also do not overlook the possibility that certain depreciable assets used in the processing of farm products may be eligible for the special two-year write-off for manufacturing and processing assets (see Chapter 11).

Effect of the investment tax credit on the capital cost of depreciable assets

If a farm business acquires a depreciable asset that qualifies for the investment tax credit (see details in Chapter 8) then, at the time the credit is utilized, the amount of the credit, which in British Columbia will generally range from 7% to 10% of the cost of the asset, must be deducted from the capital cost of the property.

Government Grants

Government grants or loan forgiveness may be income or capital in nature. If income, the grant will increase the net income or reduce the net loss. A capital grant will generally reduce the capital cost upon which capital cost allowance is claimed. Further information is available in Revenue Canada's Interpretation Bulletins IT-273R and 276.

Lease-Purchase Arrangements

Where a taxpayer acquires a property previously leased after December 11, 1979, and later sells it, the Income Tax Act contains a provision under which the recapture of lease payments is possible. In other words, amounts deducted in prior years could be brought back into income.

Change of control of a corporation - effect on undepreciated capital cost of Part XI property

If control of a farm corporation changes, the undepreciated capital cost (U.C.C.) of Part XI depreciable property owned by the corporation is reduced to its fair market value. This reduction is done on a class by class basis. The amount deducted from the U.C.C. is added to the corporation's non-capital loss carry-forward.

Reduced capital cost allowance in the year of purchase

Capital cost allowances that may be claimed in the year of purchase on Part XI property is generally restricted to one-half of the amount that would otherwise be available. This restriction applies to most property acquired after November 12, 1981. Accordingly, if a farmer constructs a farm building in his 1986 taxation year at a cost of $25,000 that ordinarily could be depreciated at the rate of 10%, the maximum capital cost allowance that may be claimed on this building in 1986 will be 1/2 x 10% x $25,000 = $1,250.

Interest during construction

As a result of rules put into the Income Tax Act in 1981, interest incurred after 1981 on amounts borrowed to construct or renovate farm buildings must be added to the cost of the building for the period during which the construction or renovation was carried on. These rules also apply to other costs incurred during the construction period that relate to the building project.

Chapter 8

THE INVESTMENT TAX CREDIT: A TAX INCENTIVE FOR CAPITAL EXPANSION

This tax incentive was introduced in the mid 1970's to stimulate investment in buildings, machinery and equipment by certain Canadian businesses. In the subsequent years, the government "tinkered" with the rules almost constantly - gradually extending and amplifying the incentive. Then in 1986, the government announced that the system is to be phased out in most cases, with the phase-out scheduled to begin on January 1, 1987.

Because the credits will continue to be available for two more years, we will briefly outline some of the rules which apply and mention a few planning points that farmers might want to keep in mind.

What is the investment tax credit?

The investment tax credit is based on the capital cost of certain types of property acquired within certain time limits. A taxpayer, whether an individual, a member of a partnership or a corporation, may claim the investment tax credit to reduce the amount of federal income tax that is otherwise payable. British Columbia income taxes are not reduced by the investment tax credit.

What are the effective dates?

The investment tax credit will apply for acquisitions of prescribed buildings or prescribed machinery and equipment acquired after June 23, 1975. Certain expenditures for scientific research made after March 31, 1977 and acquisitions of certain transportation equipment after November 16, 1978, will also qualify for the credit.

What types of property will qualify for the credit?

The credit applies to certain buildings and also to certain machinery and equipment which are purchased after the relevant dates and are used for prescribed purposes. The property acquired must have been unused at the date of purchase. If property is acquired that has been extensively renovated immediately prior to the acquisition, and the renovations are such that it can be argued that the property in its renovated state was not used before, then the investment tax credit may still be available.

The cost of a pick-up truck or car used in the farming business, does not qualify for the credit. The cost of additions to the farmer's home also does not qualify.

Equipment qualifying for the transportation tax credit includes a truck, tractor or trailer used for the purpose of carrying property in the course of a transportation business. There is an exclusion for property acquired principally for hauling or carrying freight locally.

What particular activities will qualify?

The investment tax credit is available if qualifying property is acquired for use in certain activities. The activities of interest to farmers are as follows:

a) farming, as that term is defined in the Income Tax Act;
b) the storing of grain, and
c) manufacturing or processing of goods for sale or lease.

There are other activities which qualify but they do not ordinarily affect farmers.

What is the rate of the investment tax credit?

The calculation of the credit will depend on the date the property is acquired, the location in which the property is used and, if it is a scientific research expenditure, the nature of the taxpayer making the expenditure. The minimum credit available for acquisitions of eligible property between June 2, 1975 and November 16, 1978 was 5% of the capital cost of the property. The minimum credit available for purchases after November 16, 1978 and before 1987 is 7% of the capital cost of the property.

Higher rates will apply to assets acquired for use in certain geographical regions of British Columbia. Assets acquired in the period June 1, 1977 to November 16, 1978 for use in those parts of northern British Columbia which are designated for purposes of the Regional Development Incentives Program will qualify for a 7.5% rate of credit. Property acquired after November 16, 1978 and before 1987 for use in these designated areas will qualify for a 10% rate of credit. Reference should be made to the relevant Farm Business Management factsheet for a map showing the regions in British Columbia which qualify for the higher rates of investment tax credit.

As a result of the phase-out of the majority of the credits, the rates that will apply in 1987 and future years are as follows:

	Rates Effective January 1		
	1987	1988	1989
Expenditures which qualify for a 7% credit in 1986	5%	3%	NIL
Expenditures which qualify for a 10% credit in 1986	7%	3%	NIL

A rate of 50% applies to the acquisition of manufacturing and processing plant and equipment in designated areas (the Peace River area) after October 28, 1980 and before 1987. A rate of 40% applies to this type of property if acquired in 1987, under certain circumstances.

Expenditures (whether of a current or capital nature) made for the purpose of scien ific research after March 31, 1977 will qualify for the investment tax credit at rates which range from 5% to 25% depending upon the time that the expenditure was incurred, the geographical area, and the specific type of taxpayer who incurred the expenditures. These credits are not being phased out at the present time.

If the amount of the credit available is not used in the year that it arises, can it be carried forward or backwards?

Yes. The investment tax credit in respect of expenditures after April 19, 1983 may be carried forward for up to seven years and back for up to three years. The credit for expenditures made prior to April 20, 1983 may be carried forward for only five years and there is no carryback.

Is there discretion available to the taxpayer as to how much of the credit he claims each year?

The same discretion principle that applies for claiming capital cost allowance applies to the investment tax credit as well. The taxpayer has the choice of claiming any amount up to the maximum allowed each year. The formula for calculating the maximum amount depends on the date on which the expenditure was incurred. If it was incurred before April 20, 1983, the formula is as follows:

The lesser of:

a) The taxpayer's investment tax credit available at the end of the year;
b) $15,000 plus half the amount by which the federal income tax otherwise payable by him for the year exceeds $15,000.

If the expenditure was incurred after April 19, 1983, federal taxes may be reduced on a dollar for dollar basis by the amount of the credits available - irrespective of the amount of the reduction.

If the taxpayer chooses not to claim any investment tax credit for the year, or something less than the maximum available to him, then any excess can be carried forward to the next taxation year.

What happens if there is no income tax payable?

If the credit arises in respect of an expenditure after April 19, 1983 and before 1989 a portion of the credit is refundable to the taxpayer whether or not there are any federal taxes payable. The portion that is refunded is deducted from the credit that is available for carry-forward. The refundable portion for individuals and most Canadian-controlled small business corporations is 40%. The refundable portion for large corporations is 20%.

How does the investment tax credit affect claims for capital cost allowances?

The amount of the investment tax credit claimed will normally reduce the base on which the claim for capital cost allowance can be made. Thus, where a depreciable asset which qualifies for the credit cost $100 and the amount of

the credit is $7 then the basis on which capital cost allowances may be claimed is only $93.

Does a recapture of the investment tax credit occur when an asset is sold?

No. Even though a depreciable asset is sold shortly after the investment tax credit claim has been made, no recapture of the tax credit per se will occur.

What form must be filed for making the claim for the investment tax credit?

A taxpayer should file Form T2038 to claim the investment tax credit. There are separate forms for individuals and corporations. Farmers should review their acquisitions in previous years to make sure that all possible claims for the investment tax credit have been set up. Care should also be exercised to make sure that the credit has been properly calculated. As mentioned above, the rate may vary depending on the geographical area in the province in which the farming business is located as well as the particular time that the qualifying property was acquired. Where scientific research costs are involved, the type of taxpayer making the claim will also be a factor in governing the rate of the credit.

What are the special rules which apply to co-operative corporations concerning the investment tax credit?

A co-operative corporation normally distributes all or at least a substantial portion of its income as patronage dividends. Consequently, such a corporation often does not have sufficient federal income tax payable to use up the investment tax credit which might otherwise be available to it. As a result of this problem, a special rule is provided that permits a co-operative corporation to make an indirect distribution of the investment tax credit to those persons who are receiving patronage dividends from the co-op. The co-op member, who must be a resident of Canada, may receive a share of the investment tax credit on co-op assets in the form of a credit for withholding tax on his patronage dividends. Such an amount represents a share of the investment tax credit which would have otherwise been available to the co-op itself. The amount is claimed as an instalment of tax paid on the member's behalf and is shown on the information slip reporting the patronage dividends. The recipient of the patronage dividends claims it as a payment of income tax when he files his income tax return.

Investment tax credits deducted by members of a partnership

Investment tax credits earned by a partnership must be allocated to the partners. Amounts deducted by the partners from their federal income taxes payable will reduce the adjusted cost base of the partners' interests in the partnership.

Summary

The investment tax credit has been an important part of our Canadian income tax system. Most of the credits are now being phased out but because of the length of the carry-forward period, farmers may be in a position to benefit from their accumulated credits for a number of years.

Chapter 9

GOVERNMENT RIGHTS AND LICENSES

The government has recognized that under our present tax system there are many kinds of business expenditures which cannot be deducted as expenses of the current year and also cannot be depreciated over a longer period of time under the capital cost allowance system. Under the pre-1972 tax regime such amounts were appropriately called "nothings" since no tax relief was available. To help alleviate this inequity a new set of write-off rules called the eligible capital expenditure rules were introduced in 1972. Some examples of the type of expenditures covered by these rules are:

a) payments for goodwill on the purchase of a business,
b) incorporation costs,
c) certain franchises,
d) payments for government rights and licenses such as milk quota, poultry quota and similar amounts.

Since milk, poultry and other quota are the assets which have the most relevance for farmers, we will deal exclusively here with the rules which relate to government rights ("quotas"). They are a bit different from the rules which relate to other types of eligible capital expenditures.

Under the pre-1972 tax system if a farmer acquired a quota, the cost to him was not deductible for tax purposes nor were the proceeds from its sale taxable. While quotas were issued to their original holders without cost, they could generally be sold at whatever the market would bear. Under the old system such proceeds were not taxed. Under our current law, however, some complicated rules have been introduced so that, normally, at least a portion of such amounts will be taxed.

It is important to remember that even though the purchase of quota is treated under the Income Tax Act as an eligible capital expenditure, the quota itself is not a capital property. Accordingly, any income arising from the sale of quota is not eligible for the capital gains deduction (see Chapter 13).

In this chapter, we will consider what happens when:

a) A person disposes of a quota which was owned at V-day.
b) A person acquires a quota after V-day.
c) A person disposes of a quota acquired after V-day.
d) A person owns a quota at the time of his death.
e) A person transfers quota to a child by sale or gift.

a) Disposition of a quota owned at V-day

Assume that a farmer sold his quota in 1983 for $30,000. Assume also that it had a valuation day value of $10,000 and an original cost of $2,000. Here is how the tax rule operates:

1. Proceeds received $ 30,000

2. Only a certain percentage of the proceeds must be taken into account. For 1983 it is 95% x $30,000 = 28,500

   (This percentage begins at 40 percent for 1972 and increases five percent per year to 100% in 1984 and future years)

3. For government rights and licenses, owned at V-day only, however, this percentage amount shown above is not allowed to be greater than the increase in the value since V-day, which was only: $30,000 - $10,000 = 20,000

   If original cost was greater than V-day value there would be a further reduction.

4. Having reduced our percentage of proceeds to $20,000 we now divide it in half to arrive at the amount which must be included in income - 1/2 x $20,000 = 10,000

This amount will be taxed as ordinary business income in the year the quota was disposed of.

The above rules have been illustrated as they apply to the individual farmer. For farming corporations the principles are basically the same except that there are also special rules dealing with the allocation of the proceeds to the corporation's different surplus accounts for tax purposes. These rules are important in the calculation of tax on the distribution of the corporation's surplus to its shareholder.

b) Quota acquired after V-day

If a farmer acquires quota after V-day, he will have an asset which can be written off for tax purposes in a manner which is quite similar to rules followed under the capital cost allowance system (Chapter 7). These basic guidelines should be kept in mind:

1. To be eligible for a deduction the asset must have been acquired after 1971. No assets owned at V-day can be written off in this manner.

2. The asset must have been acquired for the purpose of earning income from a business carried on by the taxpayer.

3. One half of the expenditure can be written off for tax purposes at the rate of 10% per annum on a declining balance basis.

4. In a year in which a business ceases to be carried on, the amount which has not yet been written off can normally be deducted fully in that year. Certain restrictions may apply in cases where the business is carried on by a spouse or by a corporation controlled by a spouse.

c) Disposition of a quota bought after V-day

The rules applying to the sale of quotas and other government rights after V-day are the same as those applying to all other kinds of eligible capital property. These rules are as follows:

1. Assuming all of the quota is sold, the vendor of the property must take into income half of the proceeds received from the disposition of the asset.

2. The vendor may deduct from income the balance which is available for deduction for tax purposes but which has not yet been written off. This amount will be one-half of the original expenditure less any amounts deducted in previous years.

3. If only a portion of the quota is sold, one half of the proceeds is deducted from the balance of depreciable expenditures which has not been written off. The taxpayer then depreciates the net balance.

d) What happens on death with regard to these assets?

In Chapter 15 we discuss the general rule that a person's property is deemed to be disposed of at the time of his death. The rules applying to quota are such that no tax will arise from the disposition and the person inheriting the asset will be put in the same tax position as the deceased, provided the same business is carried on. Under a separate rule, this rollover treatment also applies when the asset is left to a spouse and that person carries on the same business.

e) Gift or sale of quota to a child during the owner's lifetime

A transfer of an agricultural quota to a descendant (see chapter 16 for a definition of "child") of the farmer will qualify for the same kind of "rollover" treatment that is given to land and depreciable assets used in a farming business. Such a transfer could be by way of gift or sale. If one half of the sale proceeds for the quota exceeds the balance of the depreciable portion of the expenditures which have not yet been written off, the excess will generally be included in the farmer's income.

Chapter 10

WHAT YOU SHOULD KNOW ABOUT THE TAX TREATMENT OF YOUR FAMILY HOME

Most taxpayers are aware that, as a general rule, half the amount of a person's total capital gains, less any capital losses, is included in his income for tax purposes. Any gain that an individual realizes when he sells his house, however, is still tax-free.

We would caution British Columbia farmers that the above rule might not always apply to their homes. The rules relating to this topic can become quite complex. Revenue Canada has issued Interpretation Bulletin No. IT-120 R3 on the subject which is required reading for everyone who owns a home. To provide some general guidance on this topic, we will attempt to answer a few basic questions that are relevant to British Columbia farmers.

These are:

a) What is a principal residence for income tax purposes?

b) What is the special alternative which exists for farmers only?

c) Can a husband and wife each have a property that is a principal residence?

d) What happens if you are a farmer claiming part of the farm home expenses as a deduction from your farm income each year?

e) What happens if a family home is left in trust to a spouse?

What is a principal residence for income tax purposes?

Four different elements must be fulfilled before a property will qualify as a principal residence on which the capital gain will be tax-free. These elements are as follows:

i) Housing unit

The property must be a housing unit. This includes any land on which the housing unit stands that contributes to the use and enjoyment of the housing unit (up to an acre (or 1/2 hectare in the new metric language) is accepted without dispute).

ii) Ownership

The property must be owned by the taxpayer either by himself or jointly with another person.

iii) Ordinarily inhabited

The property must be ordinarily inhabited by the taxpayer during, not necessarily throughout, each year that it is claimed as a principal residence. Seasonal residences may qualify.

iv) Designation of the property as a principal residence

Form T2091 should be filed with your tax return for the year that you dispose of a principal residence; however, if none of the gain will be taxable anyway then the tax authorities will not insist that this form be filed. Remember that each individual can designate only one property as a principal residence for any particular calendar year.

Those are the four basic requirements of a principal residence. If your property qualifies as a principal residence throughout the period you own it, the capital gain will generally be tax-free.

What is the special alternative which exists only for farmers?

The Income Tax Act allows a farmer two methods in which to calculate his exempt gain when he disposes of his farm property. The first one requires a hypothetical division of the farm into two portions. One part will be the farm house plus one or more acres which contribute to its use and enjoyment. The other part will be the rest of the farm property. A reasonable allocation of the sale proceeds must then be made between the two parts. The same allocation must be made for the adjusted cost base (in most cases the December 31, 1971 value of the farm or original cost if it was bought after that date, plus improvements). Once this is done then the capital gain on the principal residence portion and the capital gain on the rest of the farm can be calculated. The principal residence gain will be exempt from tax. The gain on the rest of the farm land will be treated in the same manner as any other capital gain which is subject to tax.

The second method is somewhat simpler to calculate because there is no need to segregate the principal residence portion of the property from the rest of the farm. Instead, the farmer will take the proceeds of disposition of the whole farm, less selling expenses, and subtract his adjusted cost base to arrive at his capital gain. He can then reduce this capital gain by an amount equal to $1,000 plus $1,000 for every year that the house has been his principal residence. Part years count as full years for this purpose. If the farmer owned his farm from November, 1975 to January, 1986, for example, his exemption would be $1,000 plus 12 x $1,000 = $13,000. To take advantage of this second method a farmer must file a special letter with his tax return which sets out certain information concerning the property.

The circumstances of each case will determine which method will be the better one to use. Farmers should at least be aware that both methods exist and that they are entitled to use the one which gives them the larger exemption. During a period of declining real estate values, the second method could produce a special tax benefit which would be available only to farmers.

c) Can a husband and wife each have a property which is a principal residence?

This used to be possible but the income tax law was amended to provide that commencing in 1982, a family may treat only one residence as its principal residence for a taxation year. So, if a farmer and his wife each own a property which qualifies as a principal residence, the capital gains that accrued to the end of 1981 on both properties will be exempt from tax. The capital gains that accrued after 1981, however, can be exempted on only one property. The complete exemption on two properties that applies in respect of capital gains accrued to the end of 1981 will apply only if each of the spouses owns one of the properties outright.

d) What if you claim farm home expenses each year?

Where a home which is located on a farm is used to earn farm income, the income tax authorities allow a farmer to claim as a business expense a certain portion of costs incurred in connection with the home. As a matter of administrative practice up to 1/4 of repairs to the home and a reasonable portion of the cost of light, power, heat, taxes, telephone and fire insurance will be allowed as business expenses to be deducted against farm income. If a home is located off the farm then no deduction for expenses will generally be allowed unless a specific part of the home was used exclusively in the course of the farming business. An example of this might be a room used exclusively as an office for maintenance of the farm records, payroll preparation and other activities of this nature. If a house on the farm is used solely for the purpose of providing lodging to hired help the full amount of expenses incurred in connection with the house will be deductible if they are paid by the farmer.

Capital cost allowance may also be claimed on the farm home. The government's administrative practice regarding the deduction of expenses also applies to the claiming of capital cost allowance. The depreciation schedule (Form T2041) which a farmer fills out each year when he files his tax return shows how the claim is made for assets depreciated on the straight-line method. The claim is made in a similar way for assets depreciated on the declining balance basis. The portion of the cost of the home, excluding the land, of course, which represents the part of the home used for farm business purposes would have to be calculated. Capital cost allowance would then be taken on this amount in the same manner as on any other farm building.

It is important to bear in mind, that when you dispose of your farm home, the fact that you have taken a deduction for capital cost allowance over the years may result in some additional income tax if recapture occurs.

One half of the capital gain on the portion of the home that is depreciated for tax purposes will be subject to income tax when the home is sold (subject to the availability of the capital gains deduction). If capital cost allowance is not claimed this portion of the capital gain may still be tax-free.

e) What happens to the principal residence exemption if a farm home is left in trust to a spouse when a farmer dies?

We mention this point because it is not uncommon for a family home to be left in trust to a spouse for the balance of her lifetime and then to the children when the spouse dies. No capital gain arises at the time the property passes to a trust created for the spouse, providing the trust meets certain conditions set out in the Income Tax Act. Even if a gain did arise at this time it would normally be fully exempt from tax because it would be a gain from the disposition of a principal residence.

What we are concerned with here is a situation where a home owned by a trust is occupied by the farmer's widow for a period of years and increases in value until either it is sold or the widow dies. One of our principal residence tests, ownership, is missing since the trust, not the widow, owns the property. In this case, the Income Tax Act provides a special rule which allows the trust to designate the property as a principal residence. The entire capital gain arising since December 31, 1971 may be exempted from tax providing the proper designation is made.

Assume a farmer owned his home from 1972 to his death in 1980, during which time it increased in value by $25,000. The home went into a spouse trust for his widow who lived in the home until her death in 1987, during which an additional increase in value of $30,000 occurred. The income tax rules are designed in such a way that both of these increases in value will be tax exempt. It is important, however, that the appropriate designation of the property as a principal residence be made by the trust when the disposition occurs, either by sale or on the death of the widow. If this designation is not made then exemption of the gain under the principal residence rules could be denied.

Chapter 11

THE REDUCED RATE OF CORPORATE TAX FOR MANUFACTURING AND PROCESSING PROFITS AND ACCELERATED WRITE-OFFS FOR MACHINERY AND EQUIPMENT

As an incentive to aid corporations which carry on manufacturing and processing activities, the federal government introduced a special deduction from tax on the profits generated by a corporation's manufacturing and processing operations. The effect of this tax reduction is to generally lower the effective tax rate on Canadian manufacturing profits by five percentage points. Under current law, corporations in British Columbia are taxed at only 18% (ignoring surtax) on the first $200,000 of manufacturing and processing profits each year. Commencing July 1, 1987, this rate will reduce to 16% (ignoring surtax).

As well as providing lower rates of corporate tax, the federal government has also introduced special fast write-off rules for certain types of machinery and equipment which are used in manufacturing and processing. This equipment, if it meets certain qualifications, can be written off fully for income tax purposes over a period of three years. (The write-off period used to be only two years but was increased to three when the Income Tax Regulations were amended to reduce by one-half the amount of depreciation that can be claimed for tax purposes in the year that an asset is acquired).

Both of these measures are important tax incentives for Canadian industry. But what application do they have for persons in the business of farming? Unfortunately, for the majority of Canadian farmers the answer is none. To begin with, farming, as it is defined for income tax purposes (see Chapter 1) is deemed not to be a manufacturing or processing activity to which the incentives would apply. However, if a farmer carries on the processing of farm products and this activity can be separated from his activities as a farmer, he may get some tax relief, provided that certain criteria are met. Revenue Canada has said that, for example, processing of farm products could include the aging of cheese and the treating of beans.

The following checklist provides farmers with a guide as to whether or not they may be entitled to the corporate tax deduction on manufacturing and processing profits. All of the conditions must be met.

a) The corporation must earn at least 10% of its gross revenue from sale or lease of Canadian manufactured or processed goods.

b) Where a corporation carries on farming as well as the processing of farm products the activities must be separated into two distinct businesses. The income from each business must be properly calculated.

c) The income from processing of farm products must not be eligible for any of the special provisions of the Act dealing with farming income. Therefore, only farmers on the accrual method, not the cash method, would qualify.

If a corporation meets all of the above tests, steps should be taken to investigate the procedures involved to calculate the special deduction from tax.

As far as the accelerated write-off for machinery and equipment is concerned, the qualifying tests outlined by the tax authorities are different. Here are the basic rules, as they apply to farmers:

a) Individuals as well as corporations may be eligible.

b) The assets must be used directly or indirectly by the taxpayer primarily in the manufacturing or processing of goods for sale or lease.

c) The assets must normally be of a type which would have been included in Class 8 for capital cost allowance purposes. Alternatively, qualifying assets could be an oil or water storage tank, a powered industrial lift truck, electrical generating equipment described in Class 9, certain types of computers and related assets, or certain portable tools used for short term rental.

If you have machinery and equipment which meets all of the above tests you may be able to claim the fast write-off. Bear in mind that it is only equipment used in a manufacturing or processing activity, which is separate and distinct from the farming activity, which can qualify.

Chapter 12

THE HOBBY FARMER

What is a hobby farmer for income tax purposes?

To understand how our income tax law works with regard to farm income and farm losses, it is necessary to distinguish three types of farmers.

1. First of all there is the person who carries on a farming operation but has no real expectation of ever making it a profitable venture. In such cases none of the expenses incurred are deductible for income tax purposes because they would not have been incurred for the purpose of earning income from a business. Instead, they would be considered to be personal or living expenses of the individual. Minor amounts of farm products sold would presumably not be subject to income tax either. Such a person would normally depend on a source of income other than his farming activities to provide for his needs.

2. Next, there is the person who can truly be said to be in the business of farming because there is a reasonable expectation of profit. However, farming is not his way of life and his chief source of income is not from farming or a combination of farming and some other activity. Because he is engaged in the business of farming with the intention of making a profit he must report his revenue and may deduct the expenses incurred to earn it. This person is often called a hobby farmer or gentleman farmer. He is treated essentially the same as a bona fide farmer except that he is restricted in the amount of the farm losses that he can claim and he is also not entitled to use the five-year block-averaging method.

   Persons who are part-time farmers will generally be included in this category. Whether or not farming or a combination of farming and some other activity constitute the person's chief source of income is the basic test in all cases. For simplicity we will refer to all persons in this category as hobby farmers.

3. The last category, of course, is the bona-fide farmer whose operations are unquestionably the chief source of his livelihood. All of the special advantages which exist for farmers under our law are available to him.

The facts in each case will always determine which of the three categories applies to a person. Many taxpayers have gone to court in an attempt to establish that they were hobby farmers or bona-fide farmers and were entitled to the restricted or full farming loss which Revenue Canada had disallowed. Despite the great number of these cases there continues to be some "grey areas"; particularly in the differentiation of a bona-fide farmer from a hobby farmer where the farming operation is large but does not constitute the individual's chief source of income. Hopefully, these "grey areas" will be removed when more cases are considered by our senior courts.

Individuals who operate farming businesses in addition to having other income-earning activities should review Revenue Canada's Interpretation Bulletin IT-322R.

We thought that the best way to discuss the rules applying to the hobby farmer would be to ask a series of questions which might be asked by a person who falls into that category of farming. Here they are:

What are the loss restrictions for hobby farmers?

If a taxpayer's chief source of income is neither farming nor a combination of farming and some other source of income, a loss sustained from the business of farming is deductible from other income only to the extent of the lesser of:

a) the farming loss for the year, or

b) $2,500 plus the lesser of

   i) one-half of the amount by which the farming loss for the year exceeds $2,500 or

   ii) $2,500.

The portion of the net farming loss that is not deductible against other income of the year is called a restricted farm loss. Such losses incurred in 1983 and subsequent years may generally be carried back three years and carried forward for ten years, but may be deducted only against farming income earned in those years. Losses incurred in 1982 and previous years may be carried back one year and carried forward for five years.

The maximum annual farm loss that a hobby farmer can deduct from other income is $5,000. In order to obtain that deduction he has to realize an actual loss of at least $7,500. The deductible loss (if incurred in 1983 or subsequent years) may be carried back three years or forward ten years in accordance with the normal rules. A deductible loss in 1982 or previous years may be carried back one year or forward five years.

We should also add that, in cases where certain scientific research expenditures have been made, these expenses may be deducted in addition to the $5,000 allowed for the year.

Can hobby farmers use the cash method of accounting for their income?

Yes. As discussed in Chapter 3 the cash method can be used to report farm income by all persons who are in the business of farming. If you raise livestock and your loss for the year exceeds the amount which would currently be deductible to you as a hobby farmer, you can bring in part or all of the value of your livestock inventory and reduce the amount of your loss. This rule gives hobby farmers who have livestock inventories considerable flexibility as to the amount of income or loss which they may report. It is another good reason for a person in the farming business to use the cash

method to report income. Hobby farmers on the cash method can also use deferred cash purchase tickets with respect to grain sales.

Can a hobby farmer use all the income-averaging methods which are available to a bona fide farmer?

No. He cannot use the five-year block-averaging calculation because only individuals whose chief source of income is from farming can use that method. However, he can use forward averaging.

Can hobby farmers use the special $1,000 per year exemption for gains on a principal residence which is situated on a farm?

Yes. As long as the property is a principal residence which is situated on land used in his farming business, it appears that a hobby farmer can use this special rule in the same manner as a bona-fide farmer. As we have outlined in Chapter 10, there are two ways in which a farmer can calculate the exempt portion of the capital gain arising on the disposition of his principal residence. He can either sever the principal residence portion from the rest of the farm to determine his exempt capital gain or he can take a special exemption of $1,000 plus $1,000 for each year he lived in the home.

Is the investment tax credit available for use by a hobby farmer?

Yes. Provided all tests for the investment tax credit (see Chapter 8) are met there is no reason why it cannot be claimed by a hobby farmer. The investment tax credit arising on farming assets can be used as a credit against federal income tax applicable to taxable income arising from any source.

Are corporations or partnerships subject to the hobby farm loss restrictions?

Yes. If neither farming nor a combination of farming and some other source of income can be said to be the chief source of income of a corporation then the loss restrictions will apply. Where the farm is carried on by a partnership the hobby farmer determination would be made for each member of the partnership. It is possible, therefore, for some members of a particular farming partnership to be treated as hobby farmers while other members would be treated as full-time farmers in their own right.

If a hobby farm is sold, what happens to the unused restricted farm losses? Are they completely unusable?

No. When a farming operation which has been subject to the hobby farm loss restrictions is disposed of, certain adjustments may be made to the cost base of the land for capital gains purposes to compensate for the fact that certain restricted farm losses have not been deductible. A special series of calculations is required to determine the portion of the restricted farm losses which can be added to the cost base of the land to minimize the capital gain.

Will hobby farmers get the same tax concessions as the bona-fide farmer when he disposes of farm property?

Generally yes. The rules discussed in Chapter 15 and Chapter 16 should be reviewed for details concerning farms owned at date of death or transferred to children during the owner's lifetime.

Can hobby farmers who are members of farming partnerships or people who own incorporated hobby farms defer income tax at date of death and at time of gift or sale of such assets to children?

Shares of a hobby-farm corporation do not qualify for the rollover at death or during the owner's lifetime. An interest in a farming partnership, on the other hand, may qualify provided that the owner, his spouse or a child was actively engaged in the particular farming operation and substantially all of the assets in the partnership were used in the business of farming.

Can hobby farmers benefit from the capital gains deduction in the same way as other farmers?

If the hobby farmer is an individual, the full capital gains deduction should be available in respect of the capital gain arising on the sale of qualified land and buildings (see Chapter 13). If, on the other hand, the hobby farmer is a corporation, the shares of the corporation will not be treated as "qualified farm property". The owner of the shares will still be able to take advantage of the capital gains deduction - but only under the "phased-in" rules applicable to non-farming property (see Chapter 13). If the hobby farmer is a member of a partnership, a capital gain arising on the sale of his partnership interest should be eligible for the full deduction provided the owner, his spouse or a child was actively engaged in the farming business and substantially all of the assets in the partnership were used in the business of farming.

Chapter 13

THE CAPITAL GAINS DEDUCTION

Introduction

One of the recent income tax changes which is of special interest to farmers is the $500,000 lifetime capital gains deduction. For most individuals, this lifetime deduction is being phased in over six years and is not completely available until 1990. Farmers, however, are given preferential treatment in that the full $500,000 is available now if the capital gain arises from the sale of "qualified farm property" (see below).

The deduction applies in respect of capital gains realized after 1984. Because only one-half of capital gains are subject to tax, the new deduction will eliminate tax on up to $250,000 of taxable capital gains (1/2 x $500,000).

The deduction is cumulative which means that the amount that can be claimed in any year can be affected by the amount claimed in previous years. If for instance a farmer realized a taxable capital gain from the sale of "qualified farm property" of $50,000 in 1985 and claimed a deduction for that amount in that year, and then realized a further taxable capital gain of $250,000 in 1986 from the sale of a similar property, the maximum deduction that could be claimed in 1986 would be $200,000. This represents the maximum deduction available ($250,000) minus the amount claimed in 1985 ($50,000).

Each member of the family is entitled to the deduction

There is no overall limit on the deduction that may be claimed by a family. In other words, if a farm is owned jointly by a husband and wife, each would be entitled to the deduction and, in total, up to $1,000,000 of capital gains could be exempt from tax. If the farm was owned jointly by three children, up to $1,500,000 of capital gains could be exempt from tax.

The deduction is available only in respect of gains on capital property

Because the deduction applies against taxable capital gains it is available only where an individual disposes of a capital property and realizes a profit. Capital properties include land and buildings used in a farming business, shares in a farming corporation and an interest in a farming partnership. Livestock and quota are not capital properties and any income from the sale of those assets will not be eligible for the deduction.

Deduction available in respect of "deemed" dispositions

As discussed in Chapters 15 and 16, property is deemed to be disposed of when it is gifted to another person and when the owner dies. If this "deemed disposition" results in a capital gain, the owner (or his personal representatives) can take advantage of the capital gains deduction to eliminate the tax that would otherwise be payable.

Calculation of the deduction

At the beginning of this Chapter, it was noted that with the exception of gains on "qualified farm property", the cumulative capital gains deduction is being phased in over a number of years to 1990. This "phase-in" is as follows:

Year	Cumulative deduction available
1985	$ 10,000
1986	25,000
1987	50,000
1988	100,000
1989	150,000
1990	250,000

In order to be treated as a "qualified farm property", the property must be one of the following:

1. Land and buildings used in a farming business by:

   - the individual, his spouse or any of his children;

   - a family farm corporation (see below) of the individual, his spouse or any of his children; or

   - a family farm partnership (see below) of the individual, his spouse or any of his children;

2. A share of the capital stock of a family farm corporation (see below); or

3. An interest in a family farm partnership (see below).

A "family farm corporation" is one whose assets consist substantially of property used in a farming business in Canada or the shares and debt of other family farm corporations. A "family farm partnership" is one whose assets consist substantially of property used in a farming business in Canada.

Land and buildings which are rented to a person outside the family by a retired farmer will nevertheless be eligible for the full deduction, irrespective of the year of sale, provided the property (or the property for which that property was substituted) was sold after 1984 and was used in farming by the farmer, his spouse or his child (or by their family farm corporation or family farm partnership):

- in the year the property was sold, or

- in at least five years during which the property was owned by the farmer, his spouse or his child.

What happens if you sell a capital property and take back debt?

If a taxpayer sells capital property in exchange for debt, he is entitled to claim a reserve for income tax purposes in respect of the unpaid proceeds, which has the effect of spreading the capital gain over a number of years. If the property being sold is a "qualified farm property" (see above), the capital gains deduction can be claimed in each year in which a portion of the capital gain is included in income. If the property is not one of those assets, however, (perhaps because it is land which was not used in farming for five years) the capital gains deduction can be claimed only in the year in which the property is sold.

Where a taxpayer has sold a capital property before 1985, any capital gains reserves carried forward into 1985 and future years are not eligible for the deduction.

What happens if a farmer sells a qualified farming property and other capital property?

This is best illustrated by an example. Assume that in 1985, a farmer sells land, buildings and equipment and realizes the following gains:

	Capital Gain	Taxable Portion
Land	$ 220,000	$ 110,000
Buildings	60,000	30,000
Equipment	30,000	15,000

Assume also that the land and buildings were used by him in farming in the year of sale and therefore meet the definition of "qualified farm property".

In this situation the farmer would be entitled to the following capital gains deduction:

In respect of his "qualified farm property" (eg. his land and buildings)	$ 140,000
In respect of his other property (but limited to the phased-in cumulative deduction in 1985)	10,000
	$ 150,000

Note that a sale of buildings and equipment may also give rise to recaptured depreciation. This type of income is not eligible for the capital gains deduction.

Impact of claiming certain types of capital losses in previous years

If an individual deducts certain special types of capital losses from ordinary income then future capital gains, up to the amount of these losses,

are not eligible for the capital gains deduction. The special types of capital losses which can be deducted from ordinary income are:

- net capital losses which were incurred before May 23, 1985 (and which may be deducted from ordinary income at the rate of up to $2,000 per year); and

- allowable business investment losses arising on the shares and debts of certain small business corporations (which may be deducted from ordinary income without limitation - provided the taxpayer has not previously claimed the capital gains deduction).

What happens if the farm is owned by a corporation?

The corporation itself will not be able to claim the capital gains deduction because the deduction is available only to individuals and certain trusts. The incorporated farmer can still take advantage of the deduction, however, by arranging to sell the shares of his corporation. Provided the corporation is a "family farm corporation" (see above) the full deduction will be available in respect of a sale after 1984.

What happens if the farm is owned by a partnership?

The government intended that where a partnership sells farming property, the capital gain realized by the partnership would retain its status and flow through to the individual partners. The partners would then be able to claim the capital gains deduction on their individual tax returns in the manner they would have been able to had they sold the property directly. Unfortunately the tax law is not worded as clearly as it should have been and there is some question as to whether the rules work in the manner they were intended to.

In telephone discussions with officials in the Department of Finance in Ottawa, the author has been assured that the government is committed to making the rules work properly. In addition, the rulings division of Revenue Canada has stated in a private interpretation that it will interpret the Income Tax Act on the basis that qualified farm property includes land and buildings owned by a partnership. Hopefully these assurances will soon be confirmed in an Interpretation Bulletin, or the Income Tax law will be changed so that there is no longer any need for concern.

Will this deduction be available forever?

Who knows! We had a major "Tax Reform" some fifteen years ago, we have had mini-reforms at intervals since that time and the government is now saying that there will be another "Reform" in the next year or two.

Some individuals with large accrued capital gains on their farms have been sufficiently concerned about the possibility of losing this deduction that they have "locked in" their entitlements by transferring their businesses to corporations. Their land would have been transferred at fair market value

and the farmers would have claimed the capital gains deduction to eliminate the tax that would otherwise have been payable. Other assets would have been transferred at their "tax values" so as to avoid any income tax liability.

A transaction such as this should be proceeded with only after receiving expert advice. The person providing that advice would not only have to concern himself with regular income taxes but also the new alternative minimum tax (see Chapter 14).

Chapter 14

THE ALTERNATIVE MINIMUM TAX

Introduction

In response to criticism that individuals earning substantial incomes could avoid paying tax by investing in tax shelters, the government has introduced the concept of a "minimum tax". This new tax is to apply commencing in 1986 and will affect not only the individuals who purchase tax-sheltered investments but also those who realize substantial capital gains. To some extent, the new tax undermines what the government is attempting to do through the capital gains deduction. On the one hand the government is attempting to encourage investment in Canada by giving individuals a generous capital gains deduction and, on the other, it penalizes individuals if they realize a significant profit from their investments.

The tax is of considerable importance to farmers because they will often realize a capital gain when they retire from farming. The gain might arise when the farm is transferred to the next generation (if the farmer chooses not to use the rollover rules - see Chapter 16) or when it is sold to an arm's length purchaser.

Conceptually, the new tax calculation is not too difficult to understand but, in practice, there are several complexities. As a result, farmers should always seek advice from their accountant if they think the new tax might apply. This advice should be sought a considerable time before entering into a transaction that might bring the new tax rules into play, so that the accountant has an opportunity of considering whether anything can be done to help the farmer.

In essence, individuals who may be affected by the new rules have two tax calculations to make. First, they must calculate their liability to the federal government under the regular method and then they must calculate their liability for the "alternative minimum tax" (AMT). If the AMT liability is higher, then:

- the individual's federal tax liability for the year becomes the higher amount;
- the individual's provincial tax liability for the year is based on the higher amount;
- the excess of the AMT over the regular tax is available for carry-forward for up to seven years;
- the carry-forward can be deducted from the individual's regular tax liability in any of the next seven years - but the amount that can be deducted in any one year cannot reduce the liability below the AMT for that year.

The above mechanism is best illustrated by an example:

Assume:

Year	Regular Tax	AMT
1986	$ 20,000	$ 25,000
1987	10,000	9,000
1988	8,000	NIL

In this example, the individual's tax liability for 1986 would be $25,000 and the $5,000 AMT carry forward ($25,000 - $20,000) would be applied as follows:

1987	$ 1,000
1988	4,000

The revised liability of the individual would, therefore, be as follows:

1986	$ 25,000
1987	9,000
1988	4,000

How is the AMT calculated?

In general terms, the AMT is calculated by taking the taxable income calculated for regular income tax purposes and adjusting it for certain "preference" items (see below). The resulting figure is then reduced by a basic exemption of $40,000 and is multiplied by a tax rate of 17% to arrive at the federal AMT. This AMT is compared to the federal liability under the regular method to determine if the AMT applies.

The adjustments that are made to taxable income to arrive at the base on which the AMT is calculated include the following:

Taxable income is increased by the so-called "preference" items:

- the non-taxable portion of capital gains (including those which are eligible for the capital gains deduction);
- contributions to retirement plans; and
- tax shelter deductions - to the extent that losses are created by deductions for Canadian exploration expenses, Canadian development expenses, Canadian oil and gas property expenses or capital cost allowance on multi-unit residential buildings or film properties.

Taxable income is reduced by:

- the "gross-up" included in income in respect of taxable dividends from Canadian corporations; and
- the basic exemption of $40,000.

Revenue Canada has developed a special form (T691) to enable individuals to make the required calculations.

How do you know if the AMT will apply?

There is no magic formula to determine this - individuals have to work through the calculations on a case by case basis. As a rule of thumb, if the so-called "preference" items summarized above exceed the individual's income computed under the regular method, he should request his accountant to make the AMT calculations. Farmers should always consider the AMT when selling their farm or transferring it to their children.

What happens on death?

As explained in Chapter 15, an individual is deemed to dispose of his assets immediately before his death. If this disposition results in a capital gain, the AMT could apply in the deceased farmer's final return. Where the AMT does apply, the excess of the AMT over the regular liability may be carried back for three previous years and applied against the farmer's regular tax liability in those years.

Is there any situation where the AMT does not apply?

There is an important exception in the AMT rules in that they do not apply in the year in which a farmer elects to block-average. This is an added reason for the farmer to use his block-averaging election carefully. He should always think ahead and be prepared to defer using the election if there is a minimal benefit. This is particularly true where he is contemplating retirement in the next one or two years and the use of the election could be very beneficial in the year of retirement.

The AMT rules also do not apply to a taxpayer who died in 1986 or to certain separate returns that can be filed in some situations.

Chapter 15

WHAT WILL HAPPEN TO THE FAMILY FARM WHEN YOU DIE?

What tax consequences arise when the owner of a farming business dies? There is no simple set of answers to this question, unfortunately, since every person's circumstances will be different. The taxes arising at the time of death could be nil in some cases, could be quite staggering in others, and will be somewhere in between for the majority.

Even though we now have a capital gains deduction (see Chapter 13) and this will eliminate some of the tax that may otherwise have arisen on death, it continues to be necessary to exercise care and to put in place some good financial and tax planning measures. After all, the farm property represents the major asset of most farmers. It has to be preserved in a sound financial position for the beneficiaries of the farmer's estate if they are going to carry on the business. In this chapter we will not have space to consider all of the ways in which taxes may be reduced when a person dies. We will limit our discussion to the major areas which we believe to be of importance to farmers from the standpoint of income taxes. These areas are:

A. The necessity of making a will.

B. The federal income tax rules relating to capital property and depreciable property at the time of death.

A. The necessity of making a will

This is a matter that cannot be stressed enough; yet, in spite of its importance, many people in British Columbia die every year without having made a valid will, causing a great deal of unnecessary problems for those left behind. In a nut shell, by making a will a person leaves instructions as to how his worldly possessions are to be distributed when he dies. The person or persons who are named as executors of the estate will collect together the deceased's assets, pay off his debts, and divide the property remaining in the way in which the will directs. Alternatively, trustees may be appointed who will hold the property in trust for a period of time according to such terms and conditions established by the deceased.

But what happens if a person dies without a will? In this case there will be no executor to look after things since no will was drawn up appointing one. The deceased person's next of kin may apply to the courts in order to be appointed as an administrator of the estate. Problems can arise at this point if no one can be found to act as an administrator or if several eligible persons argue among themselves as to who should get the job. The public trustee may then be appointed by the courts to act in this capacity. As to the division of the property, the deceased's wishes, regardless of what they might have been, will have no influence on how the property is actually divided. Since the wishes were not spelled out in a legally valid will they cannot be enforced. Instead, the property will be distributed strictly according to the rules laid down in the Estate Administration Act, which may bear no relation at all to what the deceased really wanted. Making a will

can often be one of those things that you always meant to look into but somehow never quite got around to. Do so as soon as possible! Husband and wife should both sit down with a lawyer and each should have a will drawn up if for no other reason than to avoid the administrative problems which arise when a person dies intestate (without a valid will). Wills can easily be changed and ideally they should be reviewed at regular intervals to make sure that they are up-to-date in terms of a person's wishes and his financial circumstances.

More detailed information is available in the Ministry of Agriculture and Fisheries booklet "Wills for B.C. Farmers".

B. The federal income tax rules relating to capital property at the time of death

At the time of his death a person will be considered to have disposed of certain property. For a farmer, this would mean assets such as his farm land, buildings, machinery and equipment, vehicles, and any other assets which fall into the category of capital property (including depreciable property). Special rules exist for inventories of a cash basis farmer such as livestock and crops (see chapter 6) and for eligible capital property such as quota (see chapter 9). There are also rules applying to certain resource properties and parcels of land which are held as inventory.

As a result of the deemed disposition of capital property at death, the accrued taxable capital gains and recaptured capital cost allowances will be included in in the farmer's final personal income tax return unless one of the "rollover" rules applies (see below). Of course it is only those capital gains arising since V-day that are subject to tax. But as time goes on, particularily if there is a renewed inflationary trend in our economy, most farmers will realize a large capital gain on their land. Farmers with substantial machinery and equipment may also have a large potential for recaptured capital cost allowance. As we move further away from V-day, the accrued tax liabilities on farm property will increase.

Of course, we now have the capital gains deduction (see Chapter 13) and this has reduced the tax cost of a fair market value disposition at the time of death. The tax problem is not eliminated, however, because there remains the potential for recaptured capital cost allowance which cannot be offset by the capital gains deduction. There is also the potential of the new alternative minimum tax applying where there is a substantial accrued capital gain (see Chapter 14). For these reasons, the rules in the Income Tax Act that provide for a "rollover" where property passes to a deceased person's spouse or children continue to be very important.

The first of the rollovers referred to in this Chapter is the spouse rollover and is available to anyone (including a farmer) who leaves property to a husband or wife. The second rollover has been described as the farm rollover because it is available only to farmers.

These rollovers, together with the capital gains deduction and the new alternative minimum tax, are the most important income tax considerations for owners of family farms in Canada.

1. The spouse rollover

Simply stated, this rule provides that when capital property is left to a spouse, taxable capital gains and recaptured capital cost allowance which would apply under the general rule are deferred until a later date. The tax liability is put off until the surviving spouse's death, at which time the taxable capital gains and recaptured capital cost allowance must be reported in the spouse's final income tax return. The deferral of tax will apply whether the property is bequeathed to the spouse absolutely or is distributed to a trust for the spouse for the rest of her lifetime. If a trust is used, certain requirements must be met and these should be carefully considered at the time a person's will is drafted. Your lawyer or accountant should be aware of these requirements and can advise you accordingly. If all the criteria are not met, then the trust will not qualify and the rollover treatment will be denied.

The purpose of this special rule is to recognize, in a limited way, the sense of community of property which normally exists between husband and wife. Of course, both husband and wife have equal status under the law as to ownership of property in their own right. But the family unit is respected in the Income Tax Act and the tax collector does not insist on taking his share of the family's accumulating wealth until the property passes to the next generation.

Now, because there is a rollover for capital property passing to a spouse, it does not mean that the executors of a deceased farmer should always use it. If the farmer has not used his lifetime capital gains deduction (see Chapter 13), it may be appropriate for the executors to elect to have some of the deceased's property disposed of at fair market value. The capital gain that would be created would be offset by the capital gains deduction and the deceased's spouse would then have a higher cost to compute her ultimate capital gain on the property. In deciding on the use of this fair market value election, the possibility of the alternative minimum tax applying (see Chapter 14) would have to be assessed.

2. The farm rollover for unincorporated family farms

Provided that certain criteria are met, certain capital property used in a farm can be transferred from one generation to the next without tax cost. Before 1985, this property simply "rolled" to the next generation - meaning that the new owners simply assumed the position of the deceased parent and the accrued tax liability was deferred until a later time. Under the new rules, the deceased farmer's executors have considerably more flexibility. They can elect to have the property deemed to be disposed of at its tax value (or "rollover" value) or at any higher amount that is not in excess of the property's fair market value. The amount elected becomes the cost to the new owner as well as the proceeds to the deceased taxpayer. This election mechanism allows the executors to take advantage of the deceased farmer's unused capital gains deduction and to "step-up" the cost of the property to the next generation.

Summarized below are the types of property that qualify for this treatment and the conditions that must be met:

a) Canadian property only

The property must be land or depreciable property which is situated in Canada. Only depreciable property on the declining balance basis will qualify. Straight-line depreciable property must be transferred at fair market value. As mentioned previously, special rules apply to agricultural quotas and to inventories of cash-basis farmers which will allow these properties to be "rolled to" a child as well. Inventories of accrual basis farmers are not deemed to be disposed of at the time of death.

b) Owned by the farmer

The property must be owned by the farmer at the date of death. An unincorporated farm owned jointly by a farmer with his children or his wife would qualify for rollover.

c) Used in the business of farming

Immediately before the farmer's death the property must have been used by him or his spouse or any of his children in the business of farming. Note that there is no rule that requires the children to carry on the farming business for any specified period of time after the death of the owner. Note also that the owner of the property himself does not necessarily have to have been the individual who was in the business of farming. Thus, in a situation where father has retired and is leasing the farm to his children then the rollover rules will still operate.

The rollover rules will also operate if the property was leased to a "family farm corporation" or a "family farm partnership". These are defined terms in the Income Tax Act which describe corporations and partnerships which use substantially all of their assets in the family's farming business. If the property is rented to a stranger at the time of death, the rollover rule will not apply and the property will be deemed to be disposed of at fair market value.

d) Left to a child, grandchild or great-grandchild

The farm property must be left to a child, grandchild or great-grandchild of the farmer. The person who inherits the property must be a resident of Canada at the time that the farmer died. Note that a special definition of the word "child" for tax purposes will apply. The word will include an illegitimate child of the taxpayer, a son-in-law or daughter-in-law and adopted children.

Even though the Income Tax Act requires that the farm property must pass directly to a child, Revenue Canada's administrative practice is to allow the rollover to apply if the property passes to a trust

for a minor child, in certain situations. The property must vest indefeasibly in the beneficiary. For further information you should review Revenue Canada's Interpretation Bulletins IT-349R and IT-449.

e) Transfer of ownership of property within 36 months

The ownership of the property must have been transferred to the beneficiary of the estate within 36 months.

These are the rules which must be met if the rollover rules are to apply. It is conceivable that income tax could be postponed indefinitely if the farm continues to be passed from one generation to the next.

3. Extension of the farm rollover rules to include shares of a family farm corporation and an interest in a family farm partnership.

Effective for deaths occurring after April 10, 1978, shares of a family farm corporation and an interest in a family farm partnership will qualify for the "rollover" treatment when they pass to a child of the deceased. As with inter-vivos gifts (gifts made by an individual during his lifetime - see Chapter 16), the deceased's executors have the ability to elect to transfer this type of property for any amount between the deceased's adjusted cost base (the "rollover value") and fair market value.

4. Extension of rollover rules to include a purchase by a child from the deceased's estate

In the past, the farm rollover was available only where the property passed to the next generation as a consequence of the death of the parent. The Courts interpreted the underlined phrase as meaning that the estate couldn't sell the property to one or more of the deceased's children. If it did, the property was deemed to be disposed of by the deceased parent at fair market value - regardless of the selling price to the child.

As a result of an amendment to the Act in 1985 (retroactive to 1981) this is no longer a problem. If a deceased farmer's will provides that his land and buildings are to be sold by his estate to his child at say 60% of their fair market value, the deceased's executors will still have the ability to designate the deemed proceeds to be any amount between the property's "rollover" value and its fair market value (provided all criteria are met - see above).

5. Combination of spouse rollover and farm rollover

Occasionally a farmer will want to transfer the farm to a child on his death and to do it in a manner that will enable his surviving spouse to receive the income from the farm for the remainder of his or her lifetime. He can do this by using a spouse trust. There will be a rollover when the farm passes to the trust and a further rollover when it passes out of the trust to the child.

This arrangement is not often used by farmers, but it does ensure that the farm is inherited by the children and the surviving spouse is looked after during the remainder of his or her lifetime. Effectively, the spouse trust combines the rollover that is available when property is transferred to a spouse and the rollover for property transferred directly to children.

In order for the rollover to apply, the trust for the spouse must first meet all of the normal tests necessary for the spouse rollover. Either a trust arising at the time of death or a trust established while the farmer is alive will qualify.

The rules with respect to this combination rollover are summarized below:

a) Canadian property

This test is identical to the one discussed previously on page 66.

b) Qualified spousal trust

The property must be transferred to a qualified spousal trust, whether this is a trust arising on the death of the individual or a trust established during his lifetime. Your accountant or lawyer will be aware of the requirements that must be met in order for the trust to qualify for the rollover.

c) Used in farming

Immediately before the death of the individual's spouse, (i.e., the person for whom the spousal trust was originally set up) the property must have been used in the business of farming. Note that under the present wording of the law the spouse, children or grandchildren need not be involved in the farming business. An independent manager, for example, could be hired to run the farm for the benefit of the beneficiaries. Alternatively, the land and buildings could be rented to another person for use by him in his farming business.

d) Vesting on death of the spouse

When the spouse dies, the property must be transferred or distributed to a child or children who are resident in Canada at the time of the spouse's death.

As with direct transfers of Canadian farm property (see earlier comments) the trustees can elect to have the trust dispose of the property at its "rollover" amount or at any higher value that is not in excess of its fair market value.

6. Some special rules concerning family farm corporations and interests in a family farm partnership held by a spousal trust

The rollover for farm corporations and farm partnerships will also apply in situations where the property is first transferred to a spousal trust. Some

particular planning points should be noted in this regard:

a) New trusts and trusts already established

The rollover will apply, effective April 10, 1978 (the date of the amendment to the law), for qualifying spousal trusts already in existence or for spousal trusts set up after that date.

b) Children resident in Canada

The child who ultimately inherits the property must be resident in Canada immediately before the death of the spouse for whom the trust was created. This rule becomes important in a situation where, for example, a taxpayer dies while his child is living in the United States. As long as the child takes up residence in Canada before the death of the second spouse, the rollover rule would operate.

c) Family farm partnerships or corporations

The rules allow a family farm owned by a partnership or corporation to be operated and managed by a person not related to the family members. It is important to note, however, that the corporation or partnership cannot lease its farming property to another entity; it must use the property in its own farming business.

d) The ultimate transfer to the children

Provided all of the technical rules for the spousal trust are met, then at the date of death of the second spouse the rollover to the children will be available. The normal rule regarding a deemed disposition of a trust's capital property every 21 years will not apply to this particular trust.

Again, where there is an accrued gain on the property owned by the trust, the trustees can elect to distribute the property to the children at any amount between its "rollover" amount and its fair market value.

That is a short summary of the federal income tax consequences which are applicable at the time of a farmer's death or at the time of the death of his or her spouse. If proper tax planning arrangements are made in the farmer's will, then major income tax problems can usually be avoided or deferred. The family farm corporation and family farm partnership rollovers are very beneficial for farmers. They permit them to take advantage of the tax deferrals and income-splitting possibilities that are provided by corporations and partnerships without sacrificing any flexibility in their estate planning.

Chapter 16

WHAT YOU SHOULD KNOW ABOUT GIFTS

When a resident of British Columbia makes a gift of cash or other property of any kind to another person he should be aware that tax implications may arise from his generosity. Even though we no longer have a gift tax in British Columbia, some income tax implications do remain. Gifts of property as such are not subject to tax under the federal Income Tax Act, but a disposition of property by gift may give rise to income tax on a capital gain or a recapture of capital cost allowance. A gift of land and buildings, for example, could have this result. There are special rules concerning the income arising from gifted property as well. These rules will be of interest where gifts are made to a spouse or to minor children.

If a gift of property has the effect of creating a capital gain for income tax purposes, the person making the gift may be able to claim the capital gains deduction (see Chapter 13). If the capital gain is significant, the new alternative tax rules may apply (see Chapter 14).

What form should a gift take?

Wherever possible, gifts should be made in cash, preferably by cheque. This general rule was followed during the time the British Columbia Gift Tax Act was in effect and it makes good sense from the standpoint of the federal income tax rules as well. There are several advantages to this approach.

a) It's easy.

b) It provides good documentation (in the form of the paid cheque) of the amount of the gift, the name of the person who received it, the date on which it was made and its acceptance by the person receiving it.

If it is not possible to make the gift in the form of cash, then special attention must be paid to certain income tax rules, which are discussed below.

What are the tax implications of making a gift?

As we noted before, the value of a gift is not subject to income taxes. But everyone should be aware that when property of any kind is gifted it is generally deemed to be disposed of at fair market value. As a result, accrued taxable capital gains or recaptured capital cost allowances will have to be reported in the income tax return of the person making the gift. The lifetime capital gains deduction may eliminate the taxable capital gain but will not offset the recaptured capital cost allowances.

What about a gift to a spouse?

If property other than cash is gifted between a husband and wife, the transfer is deemed to occur on a "rollover" basis. In other words, the person receiving the property inherits the transferor's cost and the accrued

capital gain or recaptured capital cost allowances is deferred until the property is disposed of to a third party or the recipient of the property dies. This deferral rule applies automatically unless the person making the gift elects to have the property disposed of at fair market value. If this election is made, the person receiving the gift is deemed to acquire the property at fair market value.

The fair market value election can be useful if the transferor spouse has unutilized capital losses or wants to claim their unused capital gains deduction. As mentioned previously, it will be necessary to consider the new alternative minimum tax.

"Farm rollovers" to children

Most of the rules dealing with the transfer of farming property to children on the death of a parent (see Chapter 15) also apply to transfers during the parents' lifetime. This means that most farm property can be transferred to children on a "rollover" basis.

As with transfers on death, a farmer can choose to transfer certain types of property to his children at an amount which exceeds his "rollover" amount. He may wish to do this if he has losses which he wants to utilize or if he is able to claim the capital gains deduction. The property which is eligible for this special treatment includes land, buildings, intangible assets (such as quota), shares of a family farm corporation and an interest in a family farm partnership.

If we assume, for instance, that a farmer owns land which has a cost of $100,000 and a fair market value of $250,000, he has the following options:

- he can simply gift the property to his children - in which case his proceeds for tax purposes will be deemed to be equal to his cost - $100,000; or

- he can sell the property to his children at any value he chooses and, generally speaking, the amount chosen will represent his proceeds of disposition for income tax purposes. However if the sales price is less than $100,000, his deemed proceeds will be increased to this amount. If the sales price is more than $250,000, his deemed proceeds will be reduced to that amount. The same principle applies to the other assets described above.

In order for a farmer to take advantage of the special rules applying to land, depreciable property and quota, the following conditions must be met:

a) Canadian property

The assets must be used in a farming business carried on in Canada. The depreciable property must be written off on the declining balance basis rather than on the straight line basis permitted for assets acquired before 1972.

b) Owned by the farmer

The property must have been owned by the farmer prior to the transfer.

c) Used in the business of farming

Immediately before the transfer of property is made, the property must have been used by the farmer, his spouse or any of his children in the business of farming. If the property is leased to a family farm corporation or a family farm partnership, for use in its farming business, it will be treated as being used in farming by the farmer and will be eligible for the special "rollover" rules.

d) Transferred to a child, grandchild or great-grandchild

The farm property must be given to a child, grandchild or great-grandchild of the farmer. This person must also be a resident of Canada. Special note should be made of the fact that the definition of a "child" for this purpose will include an illegitimate child, a son-in-law or daughter-in-law and an adopted child. In certain cases other children over whom the taxpayer may have had custody and control during his or her childhood may also qualify.

Even though the Income Tax Act requires that the farm property be transferred directly to a child, Revenue Canada's present administrative practice is to allow the rollover to apply where the property passes to a partnership, where all of the partners are children of the person transferring the property. A rollover is also permitted where property passes to trusts for minors, in certain situations. For more information you should read Interpretation Bulletin IT-268R2.

Inventory of a cash-basis farmer

The inventory of a cash-basis farmer cannot be transferred to his child on a rollover basis during his lifetime. Property of this nature that is gifted to a child will be deemed to be disposed of at fair market value and the resulting income will be taxed in the year the gift is made.

Farm corporations and farm partnerships

As mentioned previously, the shares of a family farm corporation and an interest in a family farm partnership may be gifted to children on a "rollover" basis or may be sold at any value above the "rollover" amount - provided the sale price selected does not exceed fair market value. The term "share in a family farm corporation" is defined in the Income Tax Act as meaning:

i) A share of the capital stock of a corporation that carries on the business of farming in Canada.

ii) The corporation must use all or substantially all of its property in the carrying on of that farming business.

iii) The taxpayer, his spouse, or his child must be actively engaged in the farming operation.

The phrase "substantially all" is interpreted by Revenue Canada to mean at least 90%. A property will be considered to be used in the business of farming if its primary or principal use (i.e. more than 50% of its use) is in farming.

An "interest in family farm partnership " is defined as follows:

i) An interest in a partnership that carries on the business of farming in Canada.

ii) All or substantially all of the property of the partnership must be used in carrying on that farming business.

iii) The taxpayer, his spouse, or his child must be actively engaged in carrying on the business.

As in the case of the family farm corporation, the words "substantially all of the property" are used. Presumably this would be less of a problem for a partnership than a corporation since the partnership would not normally accumulate non-farm assets in its own name as would a corporation which had undistributed surplus.

It is to be noted that the use of a corporation or partnership effectively allows a cash basis inventory to be transferred to the farmer's child during the farmer's lifetime.

The rollover privilege with regard to corporations and partnerships is beneficial for British Columbia farmers. Keep these rules in mind with regard to your estate and financial planning.

Are there any other federal income tax consequences as a result of making gifts?

As a final note, it is important to be aware of the special rules that apply where property is gifted to spouses or children. These special rules are known as the attribution rules and their purpose is quite simple. One person (being the minor child or spouse who receives the transferred property) may earn income from the transferred property or may realize a capital gain on the disposition of that property but another person, the original owner, has to pay the relevant income tax. The rules are specifically designed to prevent improper income splitting arrangements between husband and wife or between parent and child. These are some items to watch for:

a) Income from property which you transfer to your spouse or to any person under the age of 18

This income is taxable on your tax return, not on your spouse's

return or the minor child's tax return. In the case of your wife, or husband, this rule will apply as long as you remain alive, legally married and resident in Canada. In the case of children, the rule continues to apply until the year the child reaches the age of 18. However, if the gifted property is used in a business such as a farming business, these rules may not apply regardless of the child's age. Similarly, property transferred between husband and wife which is specifically used in a business operation, such as a farm, will not be subject to the income attribution rules.

b) Capital gains on property transferred to your spouse or a minor child

The same principle that applies to the income from property transferred to a spouse also applies to capital gains and capital losses realized on the disposition of such property. Only gains and losses arising after 1971 will be so affected. Capital gains on property transferred to minor children, on the other hand, do not generally attribute back to the person who formerly owned the property. There is one important exception to that rule, however, which is of interest to farmers and is discussed below.

c) Farm property transferred to minor children

If you transfer farm property to a minor child and the child sells or disposes of it before the year in which he or she reaches age 18, any capital gain or loss on the property will be taxed in your hands. A situation like this will not happen too often, but it is something to be aware of, nonetheless. The rule is necessary so that the tax law is not abused when the sale of a farm to a third party is contemplated. If a farmer first of all sells the farm to his children, and then the children sell the farm to a third party, the capital gain and recaptured capital cost allowance would be taxable in the hands of the children (probably at lower rates of tax) and the family would be able to take advantage of the childrens' capital gains deduction. This type of arrangement might still be possible, however, but only if the sale to a third party takes place after the children reach the age of 18.

d) Farm property sold to a spouse

As a result of recent changes to the Income Tax Act, the attribution rules described above dealing with property transferred to a spouse will not apply if the property is sold to the spouse at fair market value (rather than being gifted) and the following conditions are met:

1) The transferor spouse elects to have the property disposed of for tax purposes at fair market value, and

2) If the transferee spouse issues a note as part of the purchase consideration, interest is paid on the note within thirty days

of the end of each year at a rate that is not less than the "prescribed" rate in the Income Tax Act.

It should be noted that our discussion of the income attribution levels deals only with certain basic principles. Whenever a farmer is considering the transfer of property to a spouse or to a minor child, he should review Revenue Canada's bulletins and thoroughly investigate the income tax consequences.

There may often be situations where both a husband and wife have separate sources of income and each accumulates savings or investments in his or her own right. In a case where a person has a farming business, for example, and his wife works in town for a few years to help him get established, any income which is derived from the wife's savings will always remain taxable in her hands. Since it is usually beneficial from an income tax point of view to be able to split income between husband and wife, it is important that a farmer and his wife be able to prove where such funds originated. If no record is kept, and the wife has ceased to work, the tax authorities might take the position that the funds in question had originally come from the husband's earnings. In such a situation the investment income would be taxable in his hands rather than hers. To avoid any such unjust application of the attribution rules, it is prudent to keep separate accounting for each spouse's earnings and savings. In that way the income tax authorities can be readily convinced that nothing improper has been done in the reporting of the income and payment of tax.

Chapter 17

SELLING A FARM

A person in the business of farming may decide, for various reasons, to sell his farming operation. Retirement, poor health or simply a decision to give up farming may result in a decision to sell. In some cases, there may be a wish to sell the farm to those members of the family who have the desire and ability to carry on the business. In other situations a sale to a third party will be necessary. Whatever the circumstances, the sale of a farm is a complex transaction. There are many factors which should be taken into account before such a sale is made. In this study we are concerned of course with only the tax implications of such a sale, although there will also be numerous non-tax considerations. The more knowledgeable a person makes himself before the sale, the better able he will be to utilize any tax savings which are available to him. And, more importantly, he will be able to avoid those tax pitfalls which cause unduly harsh treatment at the hands of the tax collector. We would urge all persons who contemplate the sale of their farms to seek sound tax advice before entering into such a transaction. Preferably, they will seek this advice one or two years before the sale.

From a layman's viewpoint, the tax consequences resulting from the sale of a farm can be summarized by answering the following nine questions:

a) Who is selling and when is it going to occur?
b) What is he selling?
c) To whom?
d) For how much?
e) How will payment be made and what will it be applied to?
f) How will any unpaid balance of the sale price be secured?
g) What will he do with the money?
h) When did he last block average?
i) What will be his income in the year of sale and in the next seven years?

On the surface these questions appear quite simple. For example, a farmer going out of business might say "I'm selling my land, buildings, equipment, quota and livestock to my neighbour for fair market value. The sale will take place at the end of the month. He will pay me 20 percent down and the balance over the next four years under an agreement for sale which calls for a yearly installment with interest on the unpaid balance at commercial lending rates. I plan to put the money in term deposits and live off the interest as a source of income for my retirement. I last block averaged three years ago. In the year of sale my farming income (ignoring the income from the sale of assets) will be $20,000 and in the subsequent seven years my income will consist only of what I earn on the agreement for sale and my term deposits." Fair enough. This is a good outline of the proposed sale. But let us examine more closely some of our simple questions and see what tax problems lurk behind the straightforward answers which we gave. Let's look at our first question:

Who is selling and when is it going to occur?

It will be relevant to determine whether it is a proprietorship, partnership

or corporation selling the farm and when its fiscal period ends. If for instance, we are looking at the situation of a proprietorship with a non-calendar fiscal period and the sale is structured so that it occurs at the beginning of a fiscal period, the capital gains will be included in income in the calendar year in which the sale occurs and the recaptured depreciation and the income from selling quota and inventory etc. will be included in income in the following year.

All taxpayers should be able to obtain tax benefits by structuring the sale so that it occurs over two fiscal periods.

Are the properties being sold owned jointly by the farmer and his spouse? If so, perhaps each of them can take advantage of their respective capital gains deduction (Chapter 13).

What is he selling?

We now have to consider the details of all the property which is being disposed of:

a) Are there any government rights or licenses such as a milk quota? If so, special rules exist as to the tax treatment of the proceeds from the sale of such rights or licenses (Chapter 9). The income tax cost on the sale of quota will be reduced if the quota was owned by the farm business at December 31, 1971.

b) How has the farmer treated his livestock in the past for income tax purposes? If he has a basic herd his tax treatment will be different from a farmer who is on the normal inventory basis (Chapter 6). It is also possible that a farmer may have a combination of a basic herd for certain types of livestock and an inventory basis for others. In this case some of his proceeds will be fully taxable and some will not.

c) How has the farmer treated his depreciable property (buildings, vehicles, equipment, etc.) for tax purposes? When he sells his assets, the tax treatment of property which has been written off on the straight-line basis (Part XVII assets) will be different from the treatment of property handled on the declining balance basis (Part XI assets) (Chapter 7). The deduction of a terminal loss on the sale of a farm building depreciated on a declining balance basis will be restricted if the land on which the building is situated is sold at a profit. This is discussed in Chapter 7.

d) Does the sale of assets include property that was a principal residence of the farmer? If so, allocations of the proceeds which relate to the principal residence must be made and a decision taken as to which of two basic methods will be followed in calculating the exempt portion of any capital gain. Care should be taken to ensure that the principal residence exemption is utilized to the best advantage (Chapter 10).

e) Are there any inventories or accounts receivable which have not previously been reported in income because the farmer always filed his

tax return and reported income on the cash basis? If so, the value of such crop inventories or accounts receivable may be brought into income at the time of sale.

f) Are there any assets which are eligible for the capital gains deduction (Chapter 13)? If any of the properties are "qualified farm property" (Chapter 13), the full $250,000 deduction will be available irrespective of the date of sale.

The foregoing list is by no means an exhaustive summary of the types of assets which may be sold or the tax treatment attached to them. It is merely an attempt to highlight the complexity of the tax considerations which come to light under the more general question of what is being sold.

To Whom?

This question is also deceiving. In our example we considered an arm's length sale to an outside party. But if the sale is made on a non-arm's length basis, some very different tax rules apply. A sale to the farmer's children, grandchildren or great-grandchildren will involve different rules again. And if a farmer is selling his assets to a corporation in which he is a shareholder or to a partnership of which he is a member there is, once again, a different set of tax rules available. Even the sale to a third party may not be free from complications. This is particularly true if the farmer selling the property decides, for example, that the sunny climate of Arizona might make retirement years more enjoyable. If he ceases to be a resident of Canada certain reserves are not available to him. Also, by leaving Canada, he will place a responsibility on the person who bought the farm to withhold a 15% tax (the rate will vary from 15% to 25% depending on the country in which the recipient lives) from interest payments made under the financing arrangements. This amount must then be remitted to the Canadian tax authorities. By moving to the USA our retired farmer will be subject to a whole new set of tax laws and will be required to file United States tax returns.

For how much?

Under this question there are several other important questions which must be answered. First of all, if various assets are sold as a package, the proceeds from the sale must be allocated to each asset on a reasonable basis. It is wise to spell out in the sale agreement the sale proceeds applicable to each asset being sold. In addition, where the assets were owned at December 31, 1971, a V-day value must be determined for each asset which was owned at that time. Thirdly, the historical cost of each asset should be determined wherever this is known. Where no historical cost can be determined it will be considered to be nil. These calculations are necessary so as to determine the capital gains and losses, income gains and losses, recaptured capital cost allowance and terminal losses arising as a result of the sale. How the sale proceeds are allocated to the various assets will have a direct effect on the amount of income tax which must be paid as a result of the sale. The allocations which apply to the purchaser must also apply to the vendor. In some cases, the sale of certain moveable farming assets may involve British Columbia sales tax considerations.

How will payment be made and what will it be applied to?

This question does not appear to involve tax considerations at first glance. Until, that is, one considers the hardships which can arise if a person is subject to tax on income before he actually receives the cash which will enable him to pay the tax. Accordingly, in our example, where payment is going to be made over a four year period, consideration should be given to claiming a special reserve which is available to defer tax on the unrealized taxable capital gains. The availability of this reserve could have an effect on how the payment terms are structured. If payment were to be all in cash, the full amount of taxable capital gains would be taxable in the year in which the sale takes place.

A farmer's ability to claim reserves in respect of the unpaid sales proceeds has been restricted as a result of amendments to the Income Tax Act in 1981. A farmer may now claim reserves for a period up to ten years (5 years if the property is sold to a person other than his child).

In certain instances it will be appropriate to specify in the sales agreement the manner in which the cash payments are to be applied among the assets sold. The vendor's objective will be to first apply the proceeds against assets which generate little or no income for tax purposes.

How will any unpaid balance of the sale price be secured?

Closing a deal is one thing; collecting all of your money is another. With the very substantial value of many farm operations these days a farmer who is selling out is often asked to carry the balance of the unpaid purchase price. Special care should always be taken to ensure that proper legal arrangements are made to give the best security possible to the person selling. If the farmer has to repossess the farm because of non-payment by the purchaser, he should be able to recover farm assets that are worth something more than the balance of principal and interest owing to him. Where there is a mortgage foreclosure or a repossession under an agreement for sale, special income tax rules come into play.

What will he do with the money?

This is also a question which should be decided partly in the light of income tax considerations. Perhaps the farmer will want to consider the purchase of a replacement farm so that he will have the opportunity of deferring part or all of the tax arising from the sale of his first farm. This is discussed in Chapter 18.

When did he last block average?

This factor might be extremely important if the transaction will precipitate a substantial income and the tax thereon can be reduced significantly by electing to block average in the year of sale. Remember that the alternative minimum tax does not apply in the year a block averaging election is made. If the farmer cannot block average until next year, perhaps the sale can be delayed until then.

What will be his income in the year of sale and in the next seven years?

If the sale produces a significant capital gain there is the possibility that the alternative minimum tax will exceed the farmer's regular tax liability (Chapter 14). To determine this, the farmer's accountant will need to know what the farmer's total income will be in the year of sale. In addition, he will want to assess the ability of the farmer to recover this excess tax in future years and, to do this, he will need to know the farmer's income in those years.

The tax consequences to consider on the sale of a farm are many. They are also complex and this complexity can work both to the advantage or to the detriment of the farmer. For this reason, tax advice should be sought before the sale to ensure that no hardship is caused to the farmer and that use is made of every tax advantage available to him. For many farmers, the value realized when a farm is sold represents the financial accumulation of a lifetime. It is important that he enjoy the maximum amount to which he is entitled.

Chapter 18

MOVING A FARMING BUSINESS

It is not uncommon in the farming community in British Columbia for a farmer to move from one location to another. Sometimes this involves moving the entire farm; on other occasions it involves the sale of only one segment and the purchase of another. Farmers in this situation may be able to take advantage of some special tax rules.

Where a farmer acquires depreciable assets of the same class as those sold, or acquires additional quota rights, and the purchase and sale occurs in the same fiscal year, he will be able to reduce or perhaps eliminate the income inclusion that would otherwise occur in respect of recaptured depreciation and sale of quota. In the absence of any special rules, however, there would be no relief from the taxable capital gains arising from the sale of those depreciable assets or from the sale of other capital property. In addition, where the new farm assets are not acquired until the next fiscal year, there would be no relief at all from the taxation of income arising on the sale.

Several years ago, unincorporated farmers who realized taxable capital gains, recaptured capital cost allowance or taxable amounts on the disposition of quota, could purchase income-averaging annuities to alleviate some of the income tax impact. This is no longer possible, however.

In recognition of the hardships faced by all businessmen (including farmers) who relocate part or all of their business operations, the federal government has provided a special rollover, referred to here as the "business replacement rollover", to soften the tax blow. The rules were not designed specifically for farmers, but many farmers will find that they can take advantage of them.

To whom do the new rules apply?

The tax deferral advantage will be available to any business operation, whether organized as a sole proprietorship, a partnership, or a corporation. The particular assets which will be favourably treated will include:

a) Real property or an interest in real property which is a capital property used to earn income from a business. A rental property such as an apartment block or any other type of rental real estate will not qualify. Parcels of land that are held essentially for resale will not qualify either.

b) Depreciable property that is a building or a leasehold interest which comes within the definition of real property or an interest therein. It should be noted that only buildings that are depreciable on the declining balance basis will qualify for this rollover.

c) An eligible capital property such as milk quota, poultry quota and similar government rights used in the business carried on by the taxpayer. Commercial goodwill owned by a business operation would also come within this category.

When will the tax deferral be available?

The tax deferral will apply in situations where a taxpayer has sold or otherwise disposed of one or more qualifying assets during a taxation year. The taxation year in which the sale occurs is referred to as the "initial year". A replacement property must be acquired before the end of the following taxation year. This means that in normal circumstances, a farmer would have a maximum of about 24 months from the date of sale of the first property to acquire the replacement property. He could be restricted to a period of only 12 months, however, or even a shorter period if the taxation year following the "initial year" is less than twelve months.

These special rules also apply where property is expropriated, lost or destroyed. In these circumstances, an additional year is allowed for the replacement property to be acquired.

A typical example

An illustration of a situation in which these rules would be advantageous is as follows. A farmer sells land, buildings and milk quota in 1985 and acquires another dairy operation in a different part of the province in 1986. He is an unincorporated farmer and has been reporting his income for tax purposes on a calendar year basis. In such a case, he would be eligible to defer the tax on the taxable capital gain on his land, the recapture of capital cost allowance on his buildings and the taxable amount of proceeds on disposition of the milk quota. The exact mechanics of the deferral, and whether or not a full deferral is obtained, will depend upon the amount of the sale proceeds for the original properties and the cost of the replacement properties.

The taxable amounts which are deferred in this way will reduce the respective cost components of the farmer's new business assets. Generally, his new land will have an adjusted cost base equal to the amount he paid for it minus the amount of the capital gain which he deferred on the sale of the old property. Similarly, the new buildings will have a capital cost for tax purposes equal to the amount paid minus the deferred capital gain on the previous buildings. The deferred recapture of capital cost allowance is deducted from the undepreciated capital cost of the new property. The cumulative eligible capital account of the new milk quota will be reduced by the amount which would have been taxable on the sale of the old quota.

Note that in our illustration we have assumed that there is a disposition of the quota relating to the first farming operation and the purchase of new quota for the new business location. We made this assumption to illustrate how the rules work, even though a sale of quota may not in fact be necessary when a dairy farmer changes the location of his operations.

What happens if you buy the replacement property before you sell the former property?

It often happens that a farmer will purchase his new farming operation before he has sold the old one. If the replacement property is still owned when the former property is disposed of, then the rollover rules will apply.

How is the income tax deferral claimed if the replacement property is not bought until the following fiscal year?

The taxable capital gain, recapture of capital cost allowance, or taxation of a portion of the proceeds of the quota rights will have to be reported in the normal manner for the year in which the original sale takes place. When the tax return for that year is filed then any income tax which is due must be properly paid.

When the replacement property is acquired in the second fiscal year, however, then an amended tax return for the prior year must be filed claiming the advantage of the business replacement rollover.

In any situation where both transactions occur in the same fiscal year, then this refiling of tax returns is not necessary since the rollover rule can be claimed immediately.

It may be advantageous, therefore, to acquire the replacement property in the fiscal year that the former business property is sold.

What are the tests for a replacement property?

Some fairly strict guidelines apply as to what will be regarded as a replacement property. The same guidelines which govern land and buildings will also apply to eligible capital property such as quota.

The rules which will apply are as follows:

a) The replacement property must be acquired for the same or a similar use as the use to which the former property was put.

b) Where the former property was used by the taxpayer in a business, the replacement property must be used to earn income from that same business or a similar business.

c) For people who are non-residents at the time that they acquire the replacement property, certain special requirements must be met to enable Canada to tax the gain that will eventually arise on the replacement property.

It is quite clear that some of these rules will be open to interpretation depending upon the unique facts of each case. The meanings of the "same or similar use" and the "same or similar business" will be subject to particular attention by the tax authorities and tax planners alike.

Revenue Canada has indicated that the meaning of the "same or a similar business" will probably be interpreted very generously. It would appear that any activity which comes within the broad meaning of farming for income tax purposes would be considered to be the "same or a similar business" for purposes of the rollover.

The replacement property rules may be useful in a situation where a rancher wants to partially retire. The beef cattle operation that he has worked hard to build up over the years has now become too much for him and he wants to take things a little easier. He sells his land and buildings, some machinery and equipment and also his herd. Before the end of the second taxation year he buys a smaller ranch where he keeps a small herd of cattle just to keep himself active. If the figures work out, he could avoid tax on the real estate and may only have to face tax on a portion of the proceeds from the sale of cattle from his former operation.

Many other real life situations will arise where the business replacement rollover will prove to be extremely valuable. Keep it in mind in any circumstances where you are buying or selling all or part of your farm business.

CONCLUSIONS

Farming is a very capital intensive business with the result that families who choose to earn their livelihood from farming are often "asset rich" and "cash poor". Because of this, the minimization of expenditures, including those on taxes, is extremely important.

There are "rollover" rules in the Income Tax Act which allow families to pass their farms from one generation to the next without tax but some families have not structured their business affairs so that they fall within these rules. These "rollover" rules are perhaps less important than they used to be because of the new capital gains deduction. They have not become irrelevant, however, because the capital gains deduction does not apply to all farming property and, even where it does apply, there is the possibility that the new alternative minimum tax will reduce its impact.

Many families are being placed in the difficult position of trying to preserve their farms for future generations and to provide for children who are not involved in the farm. Trying to do this in a manner that will treat all children equitably, and will allow the "farming children" to operate the farm and will keep income taxes to a minimum, is often very difficult.

For these and other reasons it is important that farmers plan their affairs properly and receive good advice on the tax implications of their plans. They should remember that our tax laws are being updated constantly and these updates can have the effect of changing an appropriate strategy into an inappropriate one. You may not be able to keep up-to-date with these changes but it is important that your advisers do!